

131.
No. 11506 7627.

United States
Circuit Court of Appeals
For the Ninth Circuit.

VICTORIA L. COTTON,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Transcript of Record

In Three Volumes

Volume I

Pages 1 to 396

Upon Petitions to Review a Decision of the Tax Court
of the United States

FILED

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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APPEARANCES

For Taxpayer:

A. CALDER MACKAY,
ARTHUR McGREGOR,
HOWARD W. REYNOLDS,
ADAM Y. BENNION,
HUGH G. ARNOLD.

For Commissioner:

B. H. NEBLETT,
H. A. MELVILLE.

Docket No. 2257

VICTORIA L. COTTON,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DOCKET ENTRIES

Transferred to Judge Harlan 3/4/46.

1943

Jun. 26—Petition received and filed. Taxpayer notified. Fee paid.

Jun. 26—Copy of petition served on General Counsel.

Jul. 29—Answer filed by General Counsel.

Jul. 29—Request for hearing in Los Angeles, California, filed by General Counsel.

Jul. 31—Notice issued placing proceeding on Los Angeles, Calif., calendar. Service of answer and request made.

1944

Oct. 14—Hearing set Nov. 27, 1944, Los Angeles, Calif.

Nov. 30—Hearing had before Judge Arnold. Motion of respondent for continuance granted.

Continued to next Los Angeles calendar.
Motion for continuance and subpoena
filed at hearing.

1945

Aug. 14—Hearing set October 1, 1945, Los Angeles,
California.

Oct. 8-13-16 and 19—Hearing had before Judge
Mellott on merits. Stipulation of facts
and Stipulation to consolidate cases for
hearing filed. Amendments to answer in
both dockets lodged. Petitioner's brief
due 75 days. Respondent's brief due 60
days. Reply due 30 days.

Nov. 13—Transcript of hearing 10/8/45 filed.

Nov. 13—Transcript of hearing 10/9/45 filed.

Nov. 13—Transcript of hearing 10/10/45 filed.

Nov. 13—Transcript of hearing 10/11/45 filed.

Nov. 13—Transcript of hearing 10/12/45 filed.

Nov. 13—Transcript of hearing 10/13/45 filed.

Nov. 13—Transcript of hearing 10/16/45 filed.

Nov. 13—Transcript of hearing 10/19/45 filed.

Dec. 10—Notice of the appearance of Hugh G.
Arnold as counsel filed.

Dec. 24—Motion for extension to Jan. 17, 1946, to
file brief filed by taxpayer. 1/2/46
granted.

1946

Jan. 17—Brief filed by taxpayer. 1/17/46 copy served.

Mar. 12—Motion for extension to April 12, 1946, to file brief filed by General Counsel. 3/13/46 granted.

Apr. 2—Reply brief filed by General Counsel. Served 4/3/46.

May 9—Motion for leave to file the attached reply brief filed by taxpayer. 5/27/46 granted.

May 27—Reply brief filed by taxpayer. 5/29/46 served. [1*]

Jul. 22—Memorandum Findings of Fact and Opinion rendered, Judge Harlan. Decision will be entered under Rule 50. Copy served 7/23/46.

Aug. 19—Motion for review of report by the Full Court and Memo in support thereof filed by taxpayer.

Aug. 19—Motion for reconsideration filed by taxpayer. 8/20/46 denied.

Aug. 19—Motion for rehearing filed by taxpayer. 8/20/46 denied.

Aug. 19—Motion for leave to file brief as amici curiae, brief lodged, filed by Arthur H. Deibert, et al. 8/20/46 granted.

Aug. 21—Order, that the taxpayer's motion filed 8/19/46 asking for review by the Full Court is denied, entered.

* Page numbering appearing at top of page of original certified Transcript of Record.

1946

Oct. 18—Respondent's computation for entry of decision filed.

Oct. 21—Hearing set 12/4/46 on respondent's motion under Rule 50.

Oct. 31—Consent to settlement filed.

Nov. 12—Decision entered, Judge Arnold, Div. 12.

Nov. 18—Petition for review by U. S. Circuit Court of Appeals for the Ninth Circuit with assignments of error filed by taxpayer.

Nov. 18—Proof of Service filed.

Dec. 5—Designation of contents of record with proof of service thereon filed by taxpayer.

Dec. 5—Motion for order directing transmission of exhibits in original form filed.

Dec. 9—Order, re transmission of documents in original form in lieu of reproduction of copies in the certified record on review, entered. [2]

The Tax Court of The United States
Docket No. 2257

VICTORIA L. COTTON,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiency determined by the respondent in his deficiency letter dated May 5, 1943, bearing symbols LA:GT:90D:NAB, and as a basis for this proceeding alleges as follows:

I.

Petitioner is and at all times has been a resident of the City of San Clemente, State of California, and as such filed her gift tax returns with the Collector of Internal Revenue for the Sixth District of California.

II.

The notice of deficiency, copy of which is attached hereto and marked "Exhibit A" and made a part hereof, was mailed to petitioner on May 5, 1943.

III.

The taxes in controversy are gift taxes for the calendar year 1941 in the amount of \$7845.75.

IV.

The determination of the taxes set forth in said notice of deficiency is based upon the following errors:

(a) Respondent erred in determining a deficiency in the sum [3] of \$7845.75.

(b) Respondent erred in increasing the total net gifts made by petitioner during the year 1941 by the sum of \$70,000.00.

(c) The respondent erred in determining that the stock of the Carson Estate Company, which was the subject of the gift, had a value of \$600.00 per share and in failing to determine that the fair market value of said stock did not exceed \$175.00 per share.

V.

The facts upon which petitioner relies as a basis for this proceeding are as follows:

(1) Petitioner is and at all times has been a resident of the City of San Clemente, State of California, and as such filed her gift tax returns with the Collector of Internal Revenue for the Sixth District of California.

(2)(a) On June 5, 1941, petitioner transferred and conveyed by gift the following property to the following named individuals:

Property	Donee
100 Shares Carson Estate Company stock	Lucy Cotton
100 Shares Carson Estate Company stock	Victoria Cotton Ogden

(b) On May 31, 1941, petitioner transferred and conveyed by gift the following property to the following named individuals:

Property	Donee
Credit on notes receivable due donor—	
\$10,500.00	Lucy Cotton
Credit on notes receivable due donor—	
\$10,500.00	Victoria Cotton Ogden

(c) Petitioner had prior to the year 1941 used \$20,000.00 of the specific exemption allowed by the statute then in force. [4]

(3) In petitioner's gift tax return for the year 1941 she reported as the fair market value of the 200 shares of stock of the Carson Estate Company, the subject of the gift, the sum of \$50,000.00, or a value of \$250.00 per share. The respondent erroneously and illegally increased this value to \$600.00 per share, or a total value of \$120,000.00, which, after allowing exclusions and exemptions as set forth in the deficiency letter, determined as the value of the net gift the sum of \$113,000.00. Petitioner alleges that the fair market value of the said 200 shares of stock of Carson Estate Company on the date of gift, to-wit, June 5, 1941, did not exceed the sum of \$175.00 per share, or a total value of \$35,000.00. Petitioner therefore alleges that she overpaid her gift taxes as shown in her return for the year 1941.

Wherefore, petitioner prays that The Tax Court of the United States hear and determine this appeal

and render its decision in accordance with the foregoing, allowing the refund herein demanded.

Dated June 21, 1943.

/s/ A. CALDER MACKAY,

/s/ ARTHUR McGREGOR,

/s/ HOWARD W. REYNOLDS,

Attorneys for Petitioner. [5]

State of California,
County of Los Angeles—ss.

Victoria L. Cotton, being first duly sworn, deposes and says that she is the petitioner above-named; that she has read the foregoing petition and knows the contents thereof and that the same is true of her own knowledge, except the matters which are therein stated to be upon information and belief and that as to those matters she believes it to be true.

VICTORIA L. COTTON.

Subscribed and sworn to before me this 21st day of June, 1943.

[Seal]

MINNA A. NEWMAN,

Notary Public in and for said
County and State [6]

EXHIBIT A

Treasury Department
Internal Revenue Service
417 South Hill Street
Los Angeles, California

LA:GT:90D:NAB

May 5, 1943

Mrs. Victoria L. Cotton,
621 South Spring Street, Room 400,
Los Angeles, California.

Madam:

You are advised that the determination of your gift tax liability for the taxable year ended December 31, 1941, discloses a deficiency of \$7,845.75 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States, at its principal address, Washington, D.C., for a redetermination of the deficiency or deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the International Revenue Agent in Charge,

Los Angeles, California, for the attention of LA: Conf:90D. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,
Commissioner,

By /s/ GEORGE D. MARTIN,
Internal Revenue Agent in
Charge.

Enclosures:

Statement.

Form of waiver.

NAB:ft [7]

Statement

Gift tax year	Liability	Assessed	Deficiency
1941	\$9,743.25	\$1,897.50	\$7,845.75

In making this determination of your Federal gift tax liability, careful consideration has been given to the report of examination dated January 6, 1943.

A copy of this letter and statement has been mailed to your representative, Mr. A. Calder Mackay, 523 West Sixth Street, Los Angeles, California, in accordance with the authority contained in the power of attorney executed by you. [8]

Adjustments to Net Gifts

Schedule A of return

	Returned	Determined
Total gifts	\$71,000.00	\$141,000.00
Less: Total exclusions	8,000.00	8,000.00
	<hr/>	<hr/>
Total included amount of gifts.....	\$63,000.00	\$133,000.00
Specific exemption	20,000.00	20,000.00
	<hr/>	<hr/>
Net gifts, 1941	\$43,000.00	\$113,000.00

Explanation of Adjustments

Schedule A of return

Item 3	\$25,000.00	\$ 60,000.00
Item 4	25,000.00	60,000.00

The determined value at \$600.00 per share for stock of the Carson Estate Company, being the above Items 3 and 4, is predicated upon all relevant factors, such as earnings, dividends, fair market value of the corporate assets, its future prospects, etc. [9]

Computation of Gift Tax

	Returned	Determined
Net gifts for		
1941	\$43,000.00	\$113,000.00
Total net gifts		
for preceding		
years	0.00	0.00
	<hr/>	<hr/>
Total net		
gifts	\$43,000.00	\$113,000.00
Tax on total		
net gifts	\$ 1,725.00	\$ 8,857.50
Defense Tax.....	172.50	885.75
	<hr/>	<hr/>
Total tax payable for 1941..	\$1,897.50	\$9,743.25
Total tax assessed:		
Feb. 1942 List, Page 201, Line 7.....		1,897.50
		<hr/>
Deficiency		\$7,845.75

Received and filed June 26, 1943. [10]

[Title of Tax Court and Cause.]

ANSWER

The Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, for answer to the petition of the above-named taxpayer, admits and denies as follows:

I and II. Admits the allegations contained in paragraphs I and II of the petition.

III. Admits that the taxes in controversy are gift taxes for the calendar year 1941; denies the remainder of the allegations contained in paragraph III of the petition.

IV. Denies the allegations of error contained in paragraph IV of the petition.

V. (1) and (2) (a), (b) and (c). Admits the allegations contained in subparagraphs (1) and (2) (a), (b) and (c) of paragraph V of the petition.

(3) Admits that in petitioner's gift tax return for the year 1941 she reported as the fair market value of the 200 shares of stock of the Carson Estate Company, the subject of the gift, the sum of \$50,000.00, or a value of \$250.00 per share; denies the remainder of the allegation contained in subparagraph (3) of paragraph V of the petition.

VI. Denies each and every allegation contained in the petition not hereinbefore specifically admitted or denied.

Wherefore, it is prayed that the determination of the Commissioner be approved.

/s/ J. P. WENCHELL, BHN,
Chief Counsel, Bureau of Internal Revenue.

Of counsel:

B. H. NEBLETT,
Acting Division Counsel, Bureau of Internal Revenue.

BHN/mm 7/23/43

Received and filed July 29, 1943. [12]

The Tax Court of The United States
Docket Nos. 2257, 7583

VICTORIA L. COTTON,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

VIRGINIA CALDWELL,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

A. Calder Mackay, Esq., Arthur McGregor, Esq.,
Howard W. Reynolds, Esq., Adam Y. Bennion, Esq.,
and Hugh G. Arnold, C.P.A., for the petitioners.

H. A. Melville, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT
AND OPINION

Harlan, Judge: This is a proceeding to redetermine gift tax deficiencies found against petitioners for the calendar year 1941 as follows:

Docket No.

2257 Victoria L. Cotton\$ 7,845.75

7583 Virginia Caldwell 18,645.51

Petitioner, Victoria L. Cotton, claims that she overpaid her gift tax for 1941 on the ground that she had paid a gift tax on 200 shares of stock of the Carson Estate Company at a valuation of \$250 per share, whereas the true value of said stock was but \$175 per share.

During the hearing counsel for respondent, by permission of the Court, filed an amended answer in Docket No. 7583, Virginia Caldwell, asking for a determination of an increased deficiency based upon the claim that the fair market value of the stock of the Dominguez Estate Company, formerly determined by the Commissioner to be \$950 per share, should be determined by the Court to be \$1,000 and that the stock in the Francis Land Company, formerly determined by the Commissioner to be of the value of \$1,045 per share, should be determined by the Court to be \$1,100 per share.

The questions to be resolved herein are as follows:

- (1) What was the fair market value of 200 shares of stock of Carson Estate Company on June 5, 1941?

(2) What was the fair market value of 100 shares of the Dominguez Estate Company on August 11, 1941?

(3) What was the fair market value of 105 shares of stock of the Francis Land Company on August 11, 1941?

At the hearing the parties stipulated as follows:

That Docket Nos. 2257 and 7583 should be consolidated for hearing, consideration and opinion;

That the oral and documentary evidence and stipulation in Docket No. 2257 should be deemed to have been received also in Docket No. 7583;

That for the purposes of this proceeding any reference to the date of June 5, 1941, and any valuation as of that date shall be applicable to the date of August 11, 1941; and

That the market value of any assets stipulated or determined by the Court as of June 5, 1941, shall be deemed to be the fair market value as of August 11, 1941; and [14]

That the condensed balance sheets of the three companies and the stockholdings of the three companies introduced in evidence, bearing date of May 31, 1941, shall be considered as of June 5, 1941, prior to the gifts of stock made by the petitioners herein in 1941.

For the purpose of brevity, Dominguez Estate company will be designated as Dominguez, the

Francis Land Company will be designated as Francis and Carson Estate Company will be designated as Carson.

FINDINGS OF FACT

Dominguez, Francis and Carson were three closely owned holding companies. Dominguez had outstanding 10,499 shares of stock. 5,499 shares of this stock was held by Francis and this latter company had 5,000 shares of stock outstanding. Carson owned 1,785 shares of Francis and 1,353 of Dominguez and had outstanding 7,412 shares of stock. Each of these corporations had but one class of stock outstanding and substantially all of the shares not owned by the respective corporations, were owned by relatives of petitioners.

The condensed balance sheet of Dominguez on June 5, 1941, eliminating capital stock liabilities and surplus, is as follows:

Assets	Book Value	Stipulated Fair Market Value
Current Assets	\$ 869,889.84	\$ 869,889.84
Stocks and Bonds.....	2,059,292.29	1,141,269.74
Ranch Real Estate.....	3,741,170.35	1,629,950.00
Other Real Estate	3,133,410.63	1,631,266.69
Oil Properties		4,500,000.00*
<hr/>		
Other Assets	\$9,803,763.11	\$9,772,376.27
<hr/>		
Liabilities		
Current Liabilities	\$ 239,416.50	\$ 292,677.09

*Valuation determined by the Court after hearing in this case.

The condensed balance sheet of Francis on June

5, 1941, eliminating capital stock liabilities and surplus, is as follows:

Assets	Book Value	Stipulated Fair Market Value
Current Assets	\$ 10,919.59	\$ 10,919.59
Stocks and Bonds.....	21,630.00	21,630.00
Other Real Estate.....	50,672.31	50,672.31
Investment in Dominguez Estate Co. 5499 shs. at \$1,019 per share	5,603,865.93	4,949,100.00*
Total Assets	<u>\$5,687,087.83</u>	<u>\$5,032,321.90</u>
Liabilities		
Current Liabilities	\$ 65,241.02	\$ 85,331.34

*Determined by the Court after hearing at \$900 per share.

The condensed balance sheet of Carson on June 5, 1941, eliminating capital stock liabilities and surplus, is as follows:

Assets	Book Value	Stipulated Fair Market Value
Current Assets	\$ 201,936.05	\$ 201,936.05
Stocks and Bonds	12,688.51	None
Ranch Real Estate	885,637.50	446,418.04
Other Real Estate	528,322.04	147,200.00
Oil Properties		285,000.00*
Investments:		
Dominguez—1353 sh. at \$722	977,119.31	1,217,700.00**
Francis—1785 sh. at \$1,137	2,029,045.20	1,767,150.00**
Total Assets	<u>\$4,634,748.61</u>	<u>\$4,065,404.09</u>
Liabilities		
Current Liabilities	\$ 26.00	\$ 34,157.48

*This amount was stipulated at the hearing.

**These amounts were determined by the Court after hearing at \$900 per share for Dominguez and \$990 per share for Francis.

The earned surplus for these three companies for the years 1927 to May 31, 1941,* is as follows:

Year	Dominguez	Francis	Carson
1927	\$ 7,913.89		\$ 13,732.96
1928	(50,714.37)	\$77,427.77	18,750.81
1929	None	36,377.95	67,236.79
1930	275,266.69	29,244.78	72,689.18
1931	87,536.21	43,329.36	20,429.03
1932	52,870.12	11,250.34	48,482.01
1933	368,819.31	6,905.33	33,381.71
1934	(15,810.95)	11,685.33	71,180.16
1935	226,215.97	8,534.14	108,012.81
1936	587,204.59	8,538.04	133,927.02
1937	832,257.15	6,491.88	151,774.45
1938	1,116,176.87	4,658.83	179,554.78
1939	1,049,771.14	4,212.39	206,025.81
1940	790,124.61	2,803.53	231,369.88
1941 (to May 31) ..	749,224.21	15,119.88	253,315.11

*Due to the fact that these companies kept their books on a cash basis, the amount for 1941 is a rough estimate but is not sufficiently incorrect to affect the finding in this case.

Petitioner, Victoria L. Cotton, is a resident of San Clemente, California, and filed her gift tax return for 1941 with the collector of internal revenue for the sixth district of California.

On June 5, 1941, she gave her two daughters, Lucy Cotton and Victoria Cotton Ogden, 100 shares each of Carson stock. She valued these shares at \$250 per share and paid the tax thereon. The Commissioner determined their value to be \$600 per share.

Petitioner Virginia Caldwell is a resident of Los Angeles, California, and filed her gift tax return for 1941 with the collector of internal revenue for

the sixth district of California. On August 11, 1941, she gave to James Caldwell Cooper 25 shares of stock of Dominguez and to Grace Caldwell Cooper 75 shares of stock of Dominguez and 105 shares of Francis. [17] These gifts were reported and gift tax paid on a value of \$340 per share for the Dominguez stock and \$374 per share for the Francis stock.

The shares of these companies are not listed and are not traded or dealt in on any market.

The oil properties listed in Dominguez balance sheet consisted of royalties payable in kind or at current posted prices at the election of Dominguez. This is not an operating company. It has frequently elected to take its royalties in kind from the most valuable well and this oil has been sold at a substantial advance above posted prices. It is estimated that in these oil wells Dominguez will receive before the exhaustion of the wells 7,992,871 barrels of oil which, at the estimated posted prices, will produce a royalty income of \$9,029,979.

At the time of the gifts involved herein and for some years prior thereto there had been considerable curtailment of production in the California oil fields. Practically all of the so-called ranch real estate owned by Dominguez was not income producing but was being held for the purpose of possible development of oil properties.

For the five years prior to 1941 and the first five months of 1941 the dividends per share of Dominguez were as follows:

1936	\$61.50
1937	66.00
1938	74.00
1939	72.00
1940	72.00
1941 (5/12th of \$82).....	34.00

For the five years preceding 1941 and the first five months of 1941 the dividends paid per share by Francis were as follows: [18]

1936	\$66.50
1937	71.50
1938	78.50
1939	77.75
1940	76.25
1941 (5/12th of \$84.50).....	35.20

The total dividends paid by Carson for the five years preceding 1941 and 5/12ths of 1941 were as follows:

1936	\$230,428.00
1937	248,302.00
1938	216,869.21
1939	237,184.00
1940	237,184.00
1941 (5/12th of \$252,008).....	105,003.30

From June 1936 to April 1941 the stockholders of Dominguez made repeated transfers of the stock in said company at a valuation of \$1,000 per share. In 1940 two shares were transferred from one brother to another at a valuation of \$700 per share. In 1939 Victoria L. Cotton transferred to her two daughters 99 shares at \$1,000 per share. In the official report of Dominguez to its stockholders in 1941 it was stated that the appraised value of the stock of Dominguez was \$1,000 per share.

From October 1936 to April 1941 repeated transfers of stock in Francis occurred among the members at a valuation of \$1,100 per share. There were also a few transactions at slightly less than this amount and on January 18, 1939, Victoria L. Cotton sold 35 shares of this stock to her two daughters for a consideration of \$35,000.

From 1935 to 1940 a few sales of the stock of Carson had occurred at \$300 per share.

In 1936 Dominguez set aside a fund of \$500,000 to purchase its own stock from any of its members who desired to sell at a price not to exceed \$1,000 per share, it being the declared purpose of the directors to prevent any of this stock being sold on the open market. [19]

The fair market value of 200 shares of stock of Carson Estate Company on June 5, 1941, was \$100,000. The fair market value of 100 shares of Dominguez Estate Company on August 11, 1941, was \$90,000. The fair market value of 105 shares of stock of Francis Land Company on August 11, 1941, was \$103,950.

Additional stipulations in this record concerning the earnings and the financial operations of these three companies are incorporated herein by reference. Most of these stipulations were referred to by the various experts who testified in the case as constituting factors in their conclusions.

OPINION

This case consumed more than one week in oral hearings and resulted in 765 pages of transcribed

testimony, with numerous exhibits made up of many sheets of complicated and involved figures. Petitioner has submitted two briefs containing 290 printed pages and the respondent has answered with one of 177 pages, all of this being devoted to the analysis of the testimony of 14 experts, six submitted by the petitioner and eight by the respondent. The basic purpose of all of this outlay of effort is to establish what would have been the fair market value of the stock involved if on the basic date there had been a willing seller who would have consummated a sale with a willing buyer and neither of them being under compulsion. Needless to say, neither of these imaginary individuals has ever existed. There have been no real sales of any of this stock involving other than families of the stockholders and it has been the declared purpose of the managers of the basic company, Dominguez, that none of this stock should be sold on the open market. [20]

In this case, if it were not for the fact that the Commissioner has abandoned his original determination of value of the Dominguez stock and asked for an increased valuation, by which act he has cast some doubt upon the presumption of correctness of his determination; and also if it were not for the fact that the expert testimony produced by the Commissioner at the hearing failed in some respects to support the Commissioner's finding, we would be very much inclined in a case involving so many speculative and argumentative factors to accept the Commissioner's finding as our own and

rely on the presumption that it is correct.

The speculative factors to which we refer involve the effect of the prospect of increased taxation on the price of stock; the effect of falling interest rates generally; of the World War which some people contemplated as being inevitable in the spring of 1941; of the possibility of future price controls on the one hand and almost unlimited Government purchases on the other; of stock market fluctuations in 1941 (concerning the nature of which there is considerable dispute); of the probability of the lifting of control on production of oil wells generally; of the weight to be given in considering the price of this stock to the possession by the corporations involved of ranch land producing no present income but being held for oil well development; and of the relative merits of various methods of appraising oil well property. These were among the most frequently mentioned factors which the experts testified that they took into consideration in evaluating this stock along with the tangible assets, the past earning records and future earning prospects of these different companies.

One of petitioners' experts in speaking of these various factors and methods of appraisal said:

I used the method of making all these appraisals, wrapping them up and looking them over and weighing them and arriving at my estimate. Market value must be an estimate. It can't be a precise meticulous mathematically derived figure. It has to be an estimate. It

is based on the conception of a transaction which did not take place between two persons who do not exist.

Counsel for petitioners in their brief say of the involved character of a determination of value under conditions such as exist in the present case:

* * * This is a type of judgment which a lawyer or a judge cannot be expected to have with respect to all types of property any more, for example, than a man skilled in real estate in one part of the county would be able to express a competent opinion as to the value of land in another section of the country where local conditions are unknown to him.

It is in this last respect that the opinions of expert witnesses become material, for through them the court is able to bring sound judgment to bear upon specific facts.

With this in mind we have analyzed the evidence as to the value of this stock under the following heads: Petitioners' witnesses, respondent's witnesses, interfamily sales, and appraised value by companies and officers.

Petitioners' Witnesses

Witnesses:	Oil Royalties Owned by Dominguez	Dominguez	Shares of Stock at Issue Francis	Carson
Wents	\$2,701,361.00			
Paine	3,000,000.00	\$420.00	\$420.00	\$214.00
Lovelace		418.00	367.00	192.00
McFie		304.00	334.40	240.80
McCuen		380.00	375.80	230.00
Eitner	4,988,600.00	407.00	425.50	

Respondent's Witnesses

Witnesses:	Oil Royalties Owned by Dominguez	Dominguez	Shares of Stock at Issue Francis	Carson
Evans	\$4,000,000.00			
Webb—(100 times monthly earnings — approximate computation	5,335,000.00			
Pemberton	4,000,000.00			
Clute	4,450,000.00			
Corey	4,330,255.00			
Phillips	4,934,391.00	759.00	834.74	444.82
Gally		861.46	947.60	518.13
Grimes	4,819,070.00	933.31	1,026.64	558.78

Interfamily Sales

Dominguez	\$700 to \$1,000
Francis	\$1,000 to \$1,100
Carson	\$300.00

Intercompany Ratings

Dominguez—Board of Directors	\$1,000.00	
Francis—Book Value	1,019.00	
Carson—Book Value	722.00	\$1,137.00

After reviewing this record, examining exhibits, studying the briefs, the asset value of the stock of the respective corporations, their past earnings, the prospects of future earnings, and all speculative and other factors affecting the price of these stocks on the dates of the gifts, it is our conclusion that their fair market value on these dates was as follows:

Dominguez Estate Company Stock.....	\$900	per share
Francis Land Company Stock.....	990	“ “
Carson Estate Company Stock.....	500	“ “

Judgment will be entered under Rule 50.

Entered July 22, 1946.

[Seal] [23]

The Tax Court of The United States

Docket No. 2257

VICTORIA L. COTTON,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 7583

VIRGINIA CALDWELL,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

MOTION FOR REHEARING

Come now the petitioners above-named, by and through their counsel, and move that the report entered herein on July 22, 1946, be set aside and vacated and that the proceedings be placed upon the calendar for rehearing at Los Angeles, California.

The grounds and reasons in support of this motion are as follows:

(1) Petitioners have not been accorded a fair hearing in that

(a) The Judge who heard the evidence (Judge Mellott) took no part in deciding the case.

(b) The credibility of fourteen expert witnesses (six called by petitioners and eight by the respondent) depended upon their respective appearances and personal demeanors upon the witness stand and could not be properly appraised by simply reading the record. [24]

(c) Findings of fact were made and consideration in the opinion was given to evidence which was stated to be hearsay and mere speculation by the Judge who heard the evidence. (T. 499.)

(d) The report, on page 8, apparently abandons the definition of fair market value that was expressed by the Judge who heard the evidence and upon which petitioners were led to believe the case would be decided. (T. 603.)

(e) Findings of fact were made and consideration in the opinion was given to certain alleged intra-family sales of stock and the values at which gifts of stock were reported for gift tax purposes, as far as five years removed from the basic date. It was respondent's burden to prove that said transactions were representative sales, which he made no effort to sustain. The evidence was taken subject to petitioners' objection that it was irrelevant and incompetent as not reflecting arms-length transactions and as being too remote in point of time. If credence is to be given to this evidence the full facts surrounding the transactions should be presented and it is respondent's burden to do so.

Wherefore it is respectfully prayed that this motion be granted.

/s/ A. CALDER MACKAY,
/s/ ARTHUR McGREGOR,
/s/ HOWARD W. REYNOLDS,
/s/ ADAM Y. BENNION,
Counsel for Petitioners.

/s/ HUGH G. ARNOLD,
Of Counsel.

Filed Aug. 19, 1946.

Denied Aug. 20, 1946.

/s/ BYRON H. HARLAN,
Judge. [25]

[Title of Tax Court and Causes.]

MOTION FOR RECONSIDERATION

Come now the petitioners above named, by and through their attorneys, and move, in the event the motion for rehearing filed concurrently herewith should be denied, that the report entered herein on July 22, 1946, be set aside and vacated and the proceedings be reconsidered upon the grounds and for the reasons set forth hereinbelow.

As grounds for this motion petitioners allege as follows:

I.

The Court erred as a matter of law in finding and deciding that Dominguez Estate Company was a holding company.

II.

The Court erred as a matter of law in finding and deciding that Dominguez Estate Company was "not an operating company." [26]

The record is replete with evidence showing that the Dominguez Estate Company was not a holding company but was in fact an operating company. The stipulation and exhibits show that this company was purchasing, selling, developing and operating its real properties. Its rentals from buildings owned and operated amounted to in excess of \$180,000.00 for each of the four years immediately preceding the year 1941, while its expenses of operating such buildings for the same period were in excess of \$125,000.00 per year; and for the five months' operations in 1941 its rental income amounted to \$80,429.72 and its expenses amounted to \$37,836.70. Its income from building operations for the period from 1927 to June 5, 1941, amounted to \$1,071,896.72 and its rental expenses amounted to \$700,927.02. General and administrative expenses, in addition to those stated above, exceeded \$100,000.00 in each of the four years preceding 1941. Its ranch income from 1927 through June 5, 1941, amounted to in excess of \$400,000.00; its activities in the pur-

chasing and selling of securities and in taking oil in kind and handling and disposing of it also negative the idea that it was not an operating company. (Stip. and Ex. 4-D.)

III.

The Court erred as a matter of law in finding and deciding that the fair market value of the oil properties of Dominguez Estate Company was \$4,500,000.00 for the following reasons:

(A) There is no competent evidence to support this value.

(1) All the witnesses except Mr. Grimes and Mr. Phillips testified to a value lower than \$4,500,000.00.

(a) Mr. Grimes admittedly was not qualified as a petroleum engineer. (T. 633.)

(b) Mr. Grimes has "had very slight experience with oil [27] properties." (T. 633.)

(c) Mr. Grimes testimony with respect to the oil properties is based solely on a comparison of stock market ratios for 1940 and he admittedly had no "familiarity" with stock market conditions at the basic date, to-wit, June 5, 1941. (T. 639.)

(d) Mr. Grimes' opinion took into account the earnings from oil only in 1940 and ignored the estimated future income as stipulated by the parties. (T. 611-13.)

(e) Mr. Phillips was not familiar with the evi-

dence, having based his opinion only on Exhibit 11-K-2. (T. 548-9.)

(f) Mr. Phillips admittedly was not an oil engineer and claimed no experience in valuing oil properties. (T. 572.)

(g) Mr. Phillips' testimony as to the value was based upon a misconception of a "formula" he stated he had seen used by engineer Paine. (T. 545.)

(B) The Court erred in assuming that Mr. Eitner testified that the fair market value of the oil properties of Dominguez Estate Company was \$4,988,600.00.

(1) Mr. Eitner admittedly had "no experience" in connection with valuing of oil properties. (T. 333.) The value of the oil properties of Dominguez Estate Company of \$4,988,600.00 ascribed in the opinion to Mr. Eitner was not fair market value but merely "present worth," which was used only to make a comparison of reflected stock values in a transaction handled by Mr. Eitner's firm in 1938. This transaction involved the Dominguez Oil Fields Company. Mr. Paine had made a "present worth" determination of \$66.00 per share for the stock of this company. Mr. Eitner's firm, Blythe & Company, had purchased the stock of Dominguez Oil Fields Company for \$32.50 per share, [28] or 50% of the "present worth." (T. 341.)

(C) The Court in determining the value of the oil royalties of Dominguez Estate Company erred in failing to give proper consideration to the income

tax burden on the estimated future income of the oil properties. The Tax Court and its predecessor, the Board of Tax Appeals, as well as the Courts, have universally recognized that in valuing oil properties, and particularly in valuing the estimated future probable income therefrom, consideration must be given to the estimated future taxes which would reduce the amount of return to an investor.

(1) Mr. Grimes, government witness, was asked the following question and gave the following answer:

“Q. * * * It is a fact, Mr. Grimes, that the higher the taxes, particularly the higher the taxes on future income, the less the value would be, isn't that a fact?

A. Why, yes. I think that is self-evident.”

(2) Mr. Grimes was also shown a copy of his book on valuation and was asked the following questions and gave the following answers:

“Q. On page 99 I want to call your attention to just one item here: ‘The imposition of an income tax serves not only to reduce the amount of future income which the investor retains from the yield of the income producing property, but also to reduce the net earnings of sinking funds set aside to cover the return of the initial investments.’ You are still of that same opinion, aren't you?

A. Yes.

Q. And I will read you also another one here, where you said that: 'But when depreciation or other deductions in the nature of a capital return operate to reduce the income subject to tax, and the price which an investor is willing to pay for a property is considered as determined on the choice of a future net yield after the payment of the tax on income and proper provision for the return of capital, the problem is much more complex, as the value sought depends upon the amount of future tax.' You still maintain that same view as expressed in that?

A. Yes, I do." [29]

(3) An excerpt from Moody's of May 5, 1941, Volume 33, No. 18, reads as follows:

"Sagging prices without any heavy liquidation were seen in last week's stock market. Many stocks touched new lows. No startling news accompanied this market reaction, which seems to be due partly to war conditions involving visions of higher taxes. It has been almost universally expected that the normal taxes of corporations would be increased from 24 per cent to 30 per cent; in fact, many corporations included the rate of 30 per cent in their reports for the first quarter. It was proposed that this increase could be accomplished by imposing a surtax of six per cent on top of the normal tax of 24 per cent." (T. 647.)

(4) See also G.C.M. 45 C.B. V-1, 65.

(D) The Court erred as a matter of law in giving any credence to the testimony of respondent's witness Evans in that:

(1) Mr. Evans was not familiar with the terms of the Reyes lease, although he admitted that it would have a bearing on valuation. (T. 396.)

(2) Mr. Evans did not give any consideration or effect to the income tax burden on the estimated future income of the oil properties. (T. 399-401.)

(E) The Court erred as a matter of law in giving any credence to the testimony of respondent's witness Webb in that:

(1) Mr. Webb was not a qualified engineer and claimed no such qualification. (T. 405.)

(2) Mr. Webb was not familiar with the Reyes lease. (T. 417.)

(3) Mr. Webb was not familiar with the record, having been given for consideration only Exhibit 11-K-2: (T. 406.)

(4) Mr. Webb did not give consideration or effect to the income tax burden on the estimated future income of the oil properties. (T. 418.)

(5) Mr. Webb admitted to Judge Mellott that his method of 100 times monthly pay-out "is a very erroneous way to figure values." (T. 418.) [30]

(6) Mr. Webb expressed no opinion of value in dollars and cents. (T. 416, 420.)

(F) The Court erred as a matter of law in

giving any credence to the testimony of respondent's witness Mr. Pemberton in that:

(1) Mr. Pemberton was not familiar with the oil properties. (T. 429.)

(2) Mr. Pemberton was not familiar with the evidence, having been shown only Exhibit 11-K-2. (T. 428.)

(3) Mr. Pemberton did not give consideration or effect to the income tax burden on the estimated future income of the properties. (T. 432.)

(G) The Court erred as a matter of law in giving any credence to the testimony of respondent's witness Clute in that:

(1) Mr. Clute was not familiar with the properties to be valued.

(2) Mr. Clute did not give consideration or effect to the income tax burden on the estimated future income of the oil properties. (T. 464.)

(3) Mr. Clute's valuation was merely a mathematical formulized computation. (T. 444.)

(H) The Court erred as a matter of law in giving any credence to the testimony of respondent's witness Mr. Corby in that:

(1) Mr. Corby was not familiar with the properties. (T. 481.)

(2) Mr. Corby was not familiar with the evidence, having knowledge of only Exhibit 11-K-2. (T. 475.)

(3) Mr. Corby did not give consideration or effect to the income tax burden on the estimated future income of the oil properties. [31]

(4) Mr. Corby's testimony with respect to the pay-out is contrary to the testimony of all the other witnesses. (T. 472.)

(I) The Court erred as a matter of law in giving any credence to the testimony of respondent's witness Phillips in that:

(1) Mr. Phillips was not a qualified engineer and claimed no such qualification. In fact, he stated that he was "not equipped to pass upon the fair market value of oil properties." (T. 546.)

(2) Mr. Phillips was not familiar with the properties of the Dominguez Estate Company.

(3) Mr. Phillips was not familiar with the evidence, having been shown only Exhibit 11-K-2. (T. 548-9.)

(4) Mr. Phillips did not give consideration or effect to the income tax burden on the estimated future income of the oil properties.

(5) Mr. Phillips' testimony was based purely upon an erroneous misconception of a formula which did not exist. (T. 686.)

(6) Mr. Phillips, although not qualified to determine the value of oil properties, erroneously attempted to reflect the value thereof in the stock.

While discounting the stipulated fair market value of the other assets of Dominguez Estate Company by 25%, he allowed no such discount to the value, arrived at by erroneous formula, of the oil properties.

(J) The Court erred as a matter of law in giving any credence to the testimony of respondent's witness Mr. Grimes in that:

(1) Mr. Grimes admitted that he was not an oil engineer and had had very slight experience with oil properties. (T. 633.)

(2) Mr. Grimes, in arriving at his value, did not give consideration or effect to the income tax burden on the estimated future income of the oil properties, although he admitted that the higher the taxes on future [32] income the less the value would be. (T. 642.)

(3) Mr. Grimes, in arriving at his value of the royalties of Dominguez Estate Company, erroneously used the earnings for 1940 of several companies. The value of oil properties in California can hardly be determined by the New York stock market, with which Mr. Grimes was unfamiliar.

(4) Mr. Grimes, in arriving at his value of the stock of Dominguez Estate Company, did not even claim familiarity with the stock market conditions on June 5, 1941. In fact, he disclaimed familiarity. (T. 639.)

(5) Mr. Grimes failed to take into consideration the increase in taxes that was threatened during the

spring of 1941 and that was imminent on the basic date, to-wit, June 5, 1941. (T. 647.)

(6) Mr. Grimes, in arriving at a fictitious reflected value for the oil properties of Dominguez Estate Company, added such erroneous value to the balance sheet without making any discount whatsoever, and merely divided the total value of the assets by the number of shares, a method of valuation which has been consistently repudiated by the Tax Court and its predecessor, the Board of Tax Appeals. (T. 674.)

(7) Mr. Grimes erroneously failed to take into consideration the fact that the minority stockholder has no right to force liquidation and he based his value of the stock upon the liquidating value. He admitted that his opinion as to the fair market value would not be the same to an outsider "who was in no manner connected with the family." He stated that under such circumstances he could not base a value on the asset value.

(8) Mr. Grimes' value is based entirely upon a mathematical computation, having no relation whatsoever to the elements which the Tax Court [33] and its predecessor, the Board of Tax Appeals, have considered necessary in determining fair market value, nor to the elements required by the Commissioner's Regulations to be considered.

IV.

The Court erred as a matter of law in determining that the oil royalties of Dominguez Estate Com-

pany had a value at the basic date, June 5, 1941, of \$4,500,000.00 in that there is no evidence in the record to sustain such value. The highest value for the oil properties of Dominguez Estate Company that was given by any witness was \$4,450,000.00, and that was by Mr. Clute, whose testimony is entirely unreliable from a legal standpoint.

V.

The Court erred as a matter of law in failing to find and decide that the oil properties of the Dominguez Estate Company on June 5, 1941, had a value not in excess of \$3,000,000.00.

VI.

The Court erred in failing to give credence to the testimony of Messrs. Wents and Paine.

(A) Each of these witnesses was qualified in every respect, and as to Mr. Paine, admitted to be qualified by respondent's own witnesses. He used the method in determining the value of the oil properties that has been generally accepted in the United States and particularly in the State of California.

(1) Mr. Phillips admitted that his firm had great confidence in Mr. Paine's ability and had used him on many occasions. (T. 545.)

(2) Mr. Pemberton in his testimony verified the method adopted by Messrs. Paine and Wents. (T. 431.) The method, admittedly correct by Mr. Pemberton, proved conclusively that Mr. Pemberton's value arrived at by [34] the application of this

particular method would have been approximately \$3,000,000.00, the same as the value given by Mr. Paine, if Mr. Pemberton had considered all the facts of record, and particularly the \$1.13 price per barrel of oil for Dominguez oil.

(3) The method was proved to be correct by a comparison with the two most comparable transactions in Southern California in recent years, namely, the Grubb Estate sale and the sales of Dominguez Oil Fields Company stock, both of which took place in 1938.

(a) Mr. Pemberton testified on direct examination that he used the same method of figuring here as he had in the Grubb Estate sale. (T. 424.) He admitted on cross-examination that the current revenue derived from the Grubb Estate oil was \$1.57 per barrel; and that the sales price of the royalty reflected a value of oil in the ground of 61c per barrel, or approximately 38% of the price the oil was bringing at the surface. (T. 425-6.)

(b) On a comparable method, since the Dominguez oil is stipulated to have been \$1.13 oil at the surface, the oil in the ground should be valued at 43.2c per barrel, or 38% of \$1.13. Mr. Paine correctly testified, without contradiction, that this ratio of 38% between the value of oil in the ground and the price it brings at the surface is a fixed, constant ratio, because as the price at the surface varies the value of the oil in the ground will vary accordingly. (T. 694.)

(c) Mr. Paine's value of \$3,000,000.00 reflected a value of 40c per barrel in the ground. (T. 159.) This was also admitted by Mr. Grimes. (T. 668.)

(d) Mr. Pemberton, although admitting that the method was a sound one, could not and did not make this comparison, for he did not even know that the Dominguez oil was \$1.13 per barrel oil. He knew nothing about [35] the barrels. (T. 428.)

(e) Mr. Paine's method of substantially discounting present worth is also supported by the testimony of Mr. Pemberton, as well as by cross-examination of Mr. Phillips in respect to the Dominguez Oil Fields stock. (T. 565.)

(B) The Court erred in failing to give weight to the testimony of Mr. Wents, whose qualifications are clearly set forth in the record and whose opinion has been used many times by the United States Government. (T. 17-18.)

VII.

The Court erred as a matter of law in determining:

(A) The fair market value on June 5, 1941, of the stock of Dominguez Estate Company to be \$900.00 per share;

(B) The fair market value on June 5, 1941, of Francis Land Company stock to be \$990.00 per share;

(C) The fair market value on June 5, 1941, of the stock of Carson Estate Company to be \$500.00 per share.

VIII.

The only witness who testified that the value of the Dominguez Estate Company stock was \$900.00 or in excess thereof was Mr. Grimes.

(A) Lack of familiarity with valuation of oil properties (T. 633) and his lack of familiarity with stock market conditions on June 5, 1941 (T. 639), disqualifies his testimony and consequently demonstrates that there is no competent evidence to support the Court's finding and decision.

(B) Furthermore, Mr. Grime's opinion admittedly was based upon a mere calculation, i.e., dividing the fair market value of the assets by the number of shares outstanding, which this and other Courts have consistently held to be error as a matter of law. [36]

(C) The so-called sales do not support the values found in the report.

(1) The only sale of Dominguez stock for cash from October 3, 1936, to the basic date was between two brothers at a figure of \$700.00 per share for two shares:

(2) The only sales of Carson stock for cash in the same period were two sales comprising 94 shares at \$300.00 per share.

(3) The so-called sales by petitioner Victoria L. Cotton in 1939 referred to on page 7 of the report were to her daughters in consideration of long-term non-interest bearing notes intended to be paid from dividends declared on the stocks in the future. The so-called sales price was exactly petitioner's

income tax basis and was used in the transfer because petitioner could not deduct a loss on such a sale. The same is true of the two sales by Lucy Rasmussen. None of these transactions is credible evidence of fair market value, for they were too removed in point of time from the basic date and they were not representative, arms-length transactions, but merely intra-family transfers.

IX.

The Court erred in failing to give weight to the testimony of petitioners' witnesses with respect to the fair market value of the stock of the Dominguez Estate Company, Francis Land Company, and Carson Estate Company.

(A) All of these witnesses testified, with uncontradicted facts to support them, that stocks were selling on the basic date at substantial discounts from the fair market value of their underlying assets. Mr. Phillips, one of respondent's witnesses, testified to the same fact and applied a 25% discount. (He erred, however, in failing to apply the discount to the oil properties.) [37]

(B) Congressional enactment requires that consideration be given in valuing unlisted stock to the selling price of comparable listed securities. Respondent admits this on brief. (Page 104.) All of petitioner's witnesses made such comparisons with comparable stocks. None of respondent's witnesses did so.

X.

The Court erred as a matter of law in failing to determine:

(A) The fair market value on June 5, 1941, of the stock of Dominguez Estate Company to be not in excess of \$400.00 per share;

(B) The fair market value on June 5, 1941, of the stock of Francis Land Company to be not in excess of \$420.00 per share;

(C) The fair market value on June 5, 1941, of the stock of Carson Estate Company to be not in excess of \$230.00 per share.

XI.

Although the Honorable Judge who rendered the opinion in the above entitled matter states that all factors of valuation were considered, it appears affirmatively from the opinion that said Honorable Judge based his conclusion as to the value of the shares of stock involved in the instant matter solely on the value (erroneously determined) of the assets owned by the various corporations.

Wherefore, it is respectfully prayed that this motion be granted.

/s/ A. CALDER MACKAY,
/s/ ARTHUR McGREGOR,
/s/ HOWARD W. REYNOLDS,
/s/ ADAM Y. BENNION,
Counsel for Petitioners.

/s/ HUGH G. ARNOLD,
Of Counsel.

Filed Aug. 19, 1946.

Denied Aug. 20, 1946. Signed Byron B. Harlan,
judge. [38]

[Title of Tax Court and Causes.]

MOTION FOR REVIEW OF REPORT
BY THE FULL COURT

Whereas, the petitioners above named have filed a motion with this Honorable Court to set aside and vacate the report entered herein on July 22, 1946, and to set the proceedings for rehearing at Los Angeles, California; and [41]

Whereas, said petitioners have filed another motion with this Honorable Court seeking a reconsideration of said report in the event the first motion hereinabove mentioned should be denied; and

Whereas, in the event this Honorable Court should deny both the above motions it is believed that a miscarriage of justice will result that can be corrected only by a review of said report and the proceedings by the full Court;

Now, Therefore, said petitioners, by and through their counsel, respectfully move, upon the grounds set forth hereinbelow and for the reasons set forth in the memorandum attached hereto and made a part hereof, that said report entered by Judge Harlan in the above entitled proceedings under date of July 22, 1946, be reviewed by the full Court.

As grounds for this motion petitioners allege as follows:

I.

The Court erred as matter of law in finding and deciding that Dominguez Estate Company was a holding company.

II.

The Court erred as matter of law in finding and deciding that Dominguez Estate Company was "not an operating company." [42]

The record is replete with evidence showing that the Dominguez Estate Company was not a holding company but was in fact an operating company. The stipulation and exhibits show that this company was purchasing, selling, developing and operating its real properties. Its rentals from buildings owned and operated amounted to in excess of \$180,000.00 for each of the four years immediately preceding the year 1941, while its expenses of operating such buildings for the same period were in excess of \$125,000.00 per year; and for the five months' operations in 1941 its rental income amounted to \$80,429.72 and its expenses amounted to \$37,836.70. Its income from building operations for the period from 1927 to June 5, 1941, amounted to \$1,071,896.72 and its rental expenses amounted to \$700,927.02. General and administrative expenses, in addition to those stated above, exceeded \$100,000.00 in each of the four years preceding 1941. Its ranch income from 1927 through June 5, 1941, amounted to in excess of \$400,000.00; its activities in the purchasing and selling of securities and in taking oil in kind and handling and disposing of it also negative the idea

that it was not an operating company. [Stip. and Ex. 4-D.]

III.

The Court erred as a matter of law in finding and deciding that the fair market value of the oil properties of Dominguez Estate Company was \$4,500,000.00 for the following reasons:

(A) There is no competent evidence to support this value.

(1) All the witnesses except Mr. Grimes and Mr. Phillips testified to a value lower than \$4,500,000.00.

(a) Mr. Grimes admittedly was not qualified as a petroleum engineer. [T. 633.]

(b) Mr. Grimes has "had very slight experience with oil properties." [T. 633.]

(c) Mr. Grimes' testimony with respect to the oil properties is based solely on a comparison of stock market ratios for 1940 and he admittedly had no "familiarity" with stock market conditions at the basic date, to-wit, June 5, 1941. [T. 639.]

(d) Mr. Grimes' opinion took into account the earnings from oil only in 1940 and ignored the estimated future income as stipulated by the parties. [T. 611-13.]

(e) Mr. Phillips was not familiar with the evidence, having based his opinion only on Exhibit 11-K-2. [T. 548-9.]

(f) Mr. Phillips admittedly was not an oil engi-

neer and claimed no experience in valuing oil properties. [T. 572.]

(g) Mr. Phillips' testimony as to the value was based upon a misconception of a "formula" he stated he had seen used by engineer Paine. [T. 545.]

(B) The Court erred in assuming that Mr. Eitner testified that the fair market value of the oil properties of Dominguez Estate Company was \$4,988,600.00.

(1) Mr. Eitner admittedly had "no experience" in connection with valuing of oil properties. [T. 333.] The value of the oil properties of Dominguez Estate Company of \$4,988,600.00 ascribed in the opinion to Mr. Eitner was not fair market value but merely "present worth," which was used only to make a comparison of reflected stock values in a transaction handled by Mr. Eitner's firm in 1938. This transaction involved the Dominguez Oil Fields Company. Mr. Paine had made a "present worth" determination of \$66.00 per share for the stock of this company. Mr. Eitner's firm, Blythe & Company, had purchased the stock of Dominguez Oil Fields Company for \$32.50 per share, or 50% of the "present worth." [T. 341.]

(C) The Court in determining the value of the oil royalties of Dominguez Estate Company erred in failing to give proper consideration to the income tax burden on the estimated future income of the oil properties. The Tax Court, as well as the

Courts, has universally recognized that in valuing oil properties, and particularly in valuing the estimated future probable income therefrom, consideration must be given to the [45] estimated future taxes which would reduce the amount of return to an investor.

(1) Mr. Grimes, government witness, was asked the following question and gave the following answer:

“Q. * * * Is it a fact, Mr. Grimes, that the higher the taxes, particularly the higher the taxes on future income, the less the value would be, isn't that a fact?”

“A. Why, yes. I think that is self-evident.”

(2) Mr. Grimes was also shown a copy of his book on valuation and was asked the following questions and he gave the following answers:

“Q. On page 99 I want to call your attention to just one item here: ‘The imposition of an income tax serves not only to reduce the amount of future income which the investor retains from the yield of the income producing property, but also to reduce the net earnings of sinking funds set aside to cover the return of the initial investments.’ You are still of that same opinion, aren't you?”

A. Yes.

Q. And I will read you also another one here, where you said that: ‘But when depreciation or

other deductions in the nature of a capital return operate to reduce the income subject to tax, and the price which an investor is willing to pay for a property is considered as determined on the [46] choice of a future net yield after payment of the tax on income and proper provision for the return of capital, the problem is much more complex, as the value sought depends upon the amount of future tax.' You still maintain that same view as expressed in that? A. Yes, I do."

(3) An excerpt from Moody's of May 5, 1941, Volume 33, No. 18, reads as follows:

"Sagging prices without any heavy liquidation were seen in last week's stock market. Many stocks touched new lows. No startling news accompanied this market reaction, which seems to be due partly to war conditions involving visions of higher taxes. It has been almost universally expected that the normal taxes of corporations would be increased from 24 per cent to 30 per cent; in fact, many corporations included the rate of 30 per cent in their reports for the first quarter. It was proposed that this increase could be accomplished by imposing a surtax of six per cent on top of the normal tax of 24 per cent." [T. 647.]

(4) See also G. C. M. 45 C. B. V-1, 65.

(D) The Court erred as a matter of law in giving any credence to the testimony of respondent's witness Evans in that—

(1) Mr. Evans was not familiar with the

terms of the Reyes lease, although he admitted [47] it would have a bearing on valuation. [T. 396.]

(2) Mr. Evans did not give any consideration or effect to the income tax burden on the estimated future income of the oil properties. [T. 399-401.]

(E) The Court erred as a matter of law in giving any credence to the testimony of respondent's witness Webb in that—

(1) Mr. Webb was not a qualified engineer and claimed no such qualification. [T. 405.]

(2) Mr. Webb was not familiar with the Reyes lease. [T. 417.]

(3) Mr. Webb was not familiar with the record, having been given for consideration only Exhibit 11-K-2. [T. 406.]

(4) Mr. Webb did not give consideration or effect to the income tax burden on the estimated future income of the oil properties. [T. 418.]

(5) Mr. Webb admitted to Judge Mellott that his method of 100 times monthly pay-out "is a very erroneous way to figure values." [T. 418.]

(6) Mr. Webb expressed no opinion of value in dollars and cents. [T. 416, 420.] [48]

(F) The Court erred as a matter of law in giv-

ing any credence to the testimony of respondent's witness Mr. Pemberton in that—

(1) Mr. Pemberton was not familiar with the oil properties. [T. 429.]

(2) Mr. Pemberton was not familiar with the evidence, having been shown only Exhibit 11-K-2. [T. 428.]

(3) Mr. Pemberton did not give consideration or effect to the income tax burden on the estimated future income of the properties. [T. 432.]

(G) The Court erred as a matter of law in giving any credence to the testimony of respondent's witness Clute in that—

(1) Mr. Clute was not familiar with the properties to be valued.

(2) Mr. Clute did not give consideration or effect to the income tax burden on the estimated future income of the oil properties. [T. 464.]

(3) Mr. Clute's valuation was merely a mathematical formulized computation. [T. 444.]

(H) The Court erred as a matter of law in giving any credence to the testimony of respondent's witness Mr. Corby in that—

(1) Mr. Corby was not familiar with the properties. [T. 481.] [49]

(2) Mr. Corby was not familiar with the

evidence, having knowledge of only Exhibit 11-K-2. [T. 475.]

(3) Mr. Corby did not give consideration or effect to the income tax burden on the estimated future income of the oil properies.

(4) Mr. Corby's testimony with respect to the pay-out is contrary to the testimony of all the other witnesses. [T. 472.]

(1) The Court erred as a matter of law in giving any credence to the testimony of respondent's witness Phillips in that—

(1) Mr. Phillips was not a qualified engineer and claimed no such qualification. In fact, he stated that he was "not equipped to pass upon the fair market value of oil properties." [T. 546.]

(2) Mr. Phillips was not familiar with the properties of the Dominguez Estate Company.

(3) Mr. Phillips was not familiar with the evidence, having been shown only Exhibit 11-K-2. [T. 548-9.]

(4) Mr. Phillips did not give consideration or effect to the income tax burden on the estimated future income of the oil properties.

(5) Mr. Phillips' testimony was based purely upon an erroneous misconception of a formula which did not exist. [T. 686.]

(6) Mr. Phillips, although not qualified to determine the value of oil properties, errone-

ously [50] attempted to reflect the value thereof in the stock. While discounting the stipulated fair market value of the other assets of Dominguez Estate Company by 25%, he allowed no such discount to the value, arrived at by erroneous formula, of the oil properties.

(J) The Court erred as a matter of law in giving any credence to the testimony of respondent's witness Mr. Grimes in that—

(1) Mr. Grimes admitted that he was not an oil engineer and had had very slight experience with oil properties. [T. 633.]

(2) Mr. Grimes, in arriving at his value, did not give consideration or effect to the income tax burden on the estimated future income of the oil properties, although he admitted that the higher the taxes on future income the less the value would be. [T. 642.]

(3) Mr. Grimes, in arriving at his value of the royalties of Dominguez Estate Company, erroneously used the earnings for 1940 of several companies. The value of oil properties in California can hardly be determined by the New York stock market, with which Mr. Grimes was unfamiliar.

(4) Mr. Grimes, in arriving at his value of the stock of Dominguez Estate Company, did not even claim familiarity with the stock market conditions on June 5, 1941. In fact, he disclaimed familiarity. [T. 639.] [51]

(5) Mr. Grimes failed to take into consideration the increase in taxes that was threatened during the spring of 1941 and that was imminent on the basic date, to-wit, June 5, 1941. [T. 647.]

(6) Mr. Grimes, in arriving at a fictitious reflected value for the oil properties of Dominguez Estate Company, added such erroneous value to the balance sheet without making any discount whatsoever, and merely divided the total value of the assets by the number of shares, a method of valuation which has been consistently repudiated by The Tax Court. [T. 674.]

(7) Mr. Grimes erroneously failed to take into consideration the fact that the minority stockholder has no right to force liquidation and he based his value of the stock upon the liquidating value. He admitted that his opinion as to the fair market value would not be the same to an outsider "who was in no manner connected with the family." He stated that under such circumstances he could not base a value on the asset value.

(8) Mr. Grimes' value is based entirely upon a mathematical computation, having no relation whatsoever to the elements which The Tax Court has considered necessary in determining fair market value, nor to the elements required by the Commissioner's Regulations to be considered. [52]

IV.

The Court erred as a matter of law in determining that the oil royalties of Dominguez Estate Company had a value at the basic date, June 5, 1941, of \$4,500,000.00 in that there is no evidence in the record to sustain such value. The highest value for the oil properties of Dominguez Estate Company that was given by any witness was \$4,450,000.00, and that was by Mr. Clute, whose testimony is entirely unreliable from a legal standpoint.

V.

The Court erred as a matter of law in failing to find and decide that the oil properties of the Dominguez Estate Company on June 5, 1941, had a value not in excess of \$3,000,000.00.

VI.

The Court erred in failing to give credence to the testimony of Messrs. Wents and Paine.

(A) Each of these witnesses was qualified in every respect, and as to Mr. Paine, admitted to be qualified by respondent's own witnesses. He used the method in determining the value of the oil properties that has been generally accepted in the United States and particularly in the State of California.

(1) Mr. Phillips admitted that his firm had great confidence in Mr. Paine's ability and had used him on many occasions. [T. 545.] [53]

(2) Mr. Pemberton in his testimony veri-

fied the method adopted by Messrs. Paine and Wents. [T. 431.] The method, admittedly correct by Mr. Pemberton, proved conclusively that Mr. Pemberton's value arrived at by the application of this particular method would have been approximately \$3,000,000.00, the same as the value given by Mr. Paine, if Mr. Pemberton had considered all the facts of record, and particularly the \$1.13 price per barrel of oil for Dominguez oil.

(3) The method was proved to be correct by a comparison with the two most comparable transactions in Southern California in recent years, namely, the Grubb Estate sale and the sales of Dominguez Oil Fields Company stock, both of which took place in 1938.

(a) Mr. Pemberton testified on direct examination that he used the same method of figuring here as he had in the Grubb Estate sale. [T. 424.] He admitted on cross-examination that the current revenue derived from the Grubb Estate oil was \$1.57 per barrel; and that the sales price of the royalty reflected a value of oil in the ground of 61c per barrel, or approximately 38% of the price the oil was bringing at the surface. [T. 425-6.]

(b) On a comparable method, since the Dominguez oil is stipulated to have been [54] \$1.13 oil at the surface, the oil in the ground should be valued at 43.2c per barrel, or 38% of \$1.13. Mr. Paine correctly testified, without contradiction, that this ratio of 38% between the value of oil in the ground

and the price it brings at the surface is a fixed, constant ratio, because as the price at the surface varies the value of the oil in the ground will vary accordingly. [T. 694.]

(c) Mr. Paine's value of \$3,000,000.00 reflected a value of 40c per barrel in the ground. [T. 159.] This was also admitted by Mr. Grimes. [T. 668.]

(d) Mr. Pemberton, although admitting that the method was a sound one, could not and did not make this comparison, for he did not even know that the Dominguez oil was \$1.13 per barrel oil. He knew nothing about the barrels. [T. 428.]

(e) Mr. Paine's method of substantially discounting present worth is also supported by the testimony of Mr. Pemberton, as well as by cross-examination of Mr. Phillips in respect to the Dominguez Oil Fields stock. [T. 565.]

(B) The Court erred in failing to give weight to the testimony of Mr. Wents, whose qualifications are clearly set forth in the record and whose opinion has been used many times by the United States Government. [T. 17-18.] [55]

VII.

The Court erred as a matter of law in determining—

(A) The fair market value on June 5, 1941, of the stock of Dominguez Estate Company to be \$900.00 per share;

(B) The fair market value on June 5, 1941,

of Francis Land Company stock to be \$990.00 per share;

(C) The fair market value on June 5, 1941, of the stock of Carson Estate Company to be \$500.00 per share.

VIII.

The only witness who testified that the value of the Dominguez Estate Company stock was \$900.00 or in excess thereof was Mr. Grimes.

(A) Lack of familiarity with valuation of oil properties [T. 633] and his lack of familiarity with stock market conditions on June 5, 1941 [T. 639], disqualifies his testimony and consequently demonstrates that there is no competent evidence to support the Court's finding and decision.

(B) Furthermore, Mr. Grimes' opinion admittedly was based upon a mere calculation, i.e., dividing the fair market value of the assets by the number of shares outstanding, which this and other Courts have consistently held to be error as a matter of law. [56]

(C) The so-called sales do not support the values found in the report.

(1) The only sale of Dominguez stock for cash from October 3, 1936, to the basic date was between two brothers at a figure of \$700.00 per share for two shares.

(2) The only sales of Carson stock for cash in the same period were two sales comprising 94 shares at \$300.00 per share.

(3) The so-called sales by petitioner Victoria L. Cotton in 1939 referred to on page 7 of the report were to her daughters in consideration of long-term non-interest bearing notes intended to be paid from dividends declared on the stocks in the future. The so-called sales price was exactly petitioner's income tax basis and was used in the transfer because petitioner could not deduct a loss on such a sale. The same is true of the two sales by Lucy Rasmussen. None of these transactions is credible evidence of fair market value, for they were too removed in point of time from the basic date and they were not representative, arms-length transactions, but merely intra-family transfers.

IX.

The Court erred in failing to give weight to the testimony of petitioners' witnesses with respect to the fair market value of the stock of the [57] Dominguez Estate Company, Francis Land Company, and Carson Estate Company.

(A) All of these witnesses testified, with uncontradicted facts to support them, that stocks were selling on the basic date at substantial discounts from the fair market value of their underlying assets. Mr. Phillips, one of respondent's witnesses, testified to the same fact and applied a 25% discount. He erred, however, in failing to apply the discount to the oil properties).

(B) Congressional enactment requires that con-

sideration be given in valuing unlisted stock to the selling prices of comparable listed securities. Respondent admits this on brief. (Page 104.) All of petitioners' witnesses made such comparisons with comparable stocks. None of respondent's witnesses did so.

X.

The Court erred as a matter of law in filing to determine—

(A) The fair market value of June 5, 1941, of the stock of Dominguez Estate Company to be not in excess of \$400.00 per share;

(B) The fair market value on June 5, 1941, of the stock of Francis Land Company to be not in excess of \$420.00 per share; [58]

(C) The fair market value on June 5, 1941, of the stock of Carson Estate Company to be not in excess of \$230.00 per share.

XI.

Although the Honorable Judge who rendered the opinion in the above entitled matter states that all factors of valuation were considered, it appears affirmatively from the opinion that said Honorable Judge based his conclusion as to the value of the shares of stock involved in the instant matter solely on the value (erroneously determined) of the assets owned by the various corporations.

Wherefore, it is respectfully prayed that this motion be granted.

A. CALDER MACKAY,
ARTHUR MCGREGOR,
HOWARD W. REYNOLDS,
ADAM Y. BENNION,

Counsel for Petitioners,

HUGH G. ARNOLD,
Of Counsel. [59]

MEMORANDUM IN SUPPORT OF MOTION
FOR REVIEW OF REPORT BY THE
FULL COURT

I.

We are aware that the full Court rarely reviews a valuation question, but it is earnestly believed by petitioners that justice can be achieved in no other way in the present case, where the Judge who heard the evidence is not available to decide the issue, where a clear-cut legal question has been decided against petitioners inferentially and without any reasons being given or without even a statement of the issue, where the accepted meaning of fair market value, recognized by the Judge at the hearing, has apparently been abandoned in deciding the case, where the elements required to be considered by the regulations and decided cases have been slighted, where expert testimony introduced by both parties has been disregarded, and where the factors alleged to have been considered in the report can easily be shown not to support the values found therein.

II.

The opinion part of the report begins on page 8 by apparently ridiculing the "imaginary individuals" who traditionally have been assumed to exist in fair market valuations. In so doing, the report departs from the definition [60] of fair market value given by Judge Mellott during the trial and which the petitioners had a right to assume would be

adopted in the decision of the case. Judge Mellott stated, in apparent criticism of a witness for respondent who had merely divided the value of the assets by the number of shares outstanding, “* * * considering fair market value to mean, as no doubt what it means, * * * the price at which the hypothetical willing buyer, having knowledge of all of the facts, and the seller, having knowledge of the facts—neither being under any compulsion—would trade.” [T. 603.]

III.

The opinion proceeds on page 9 to state that since there were “speculative and argumentative” factors involved, the inclination is merely to accept the Commissioner’s determination of value. And it is stated that this was not done because (1) the Commission had abandoned his own determination, and (2) certain of the expert testimony produced by the Commissioner himself (namely, two out of three of his witnesses) failed to support his own determination. Notwithstanding these protestations, the report is tantamount to an acceptance of the Commissioner’s abandoned determination, for his determination was \$950.00 per share and the report finds a value of \$900.00 per share. [61]

The value of the stock in question turns largely upon the value determined for Dominguez stock, which in turn is largely governed by the value of its oil properties (valued in the report at \$4,500,000.00). The Commission never made a determination of the value of the oil and hence as to it there was no presumptive correctness.

Furthermore, any valuation case—and particularly one involving oil properties—must of necessity embrace factors about which there can be speculation and argument. A valuation is essentially an attempt to prophesy the future. This being inherent in every valuation case, does the present report mean to intimate that a taxpayer may not secure the independent judgment of this Honorable Court founded upon credible and competent evidence? Are all taxpayers condemned to the whim of the Commissioner in valuation matters because he can argue and speculate over matters where even his own witnesses fail to support him? The finality attributed by Dobson to The Tax Court's findings in such matters is tragic for taxpayers if this is to be the extent of their day in court.

The Tax Court has never to the knowledge of the undersigned indulged in its inclination, if any, to escape the responsibility of passing upon the factors recognized as essential in determining fair market value. The statutory presumption [62] does no more than make the taxpayer come forward with his proof. A record of 765 pages of transcribed testimony of 14 experts and printed briefs of 290 pages cannot legally be so easily ignored, even though such record may contain "speculative and argumentative" factors. As Justice Learned Hand of the Second Circuit Court of Appeals stated (*Guggenheim v. Helvering*, 117 F. (2d) 469, 474):

"* * * In appraising property of this kind, whatever courts may say, and however they

may seek to disguise what they do, it is impossible to avoid some measure of speculation. * * * A judicial duty which is inherently subject to such shortcomings must not stop half way; it is no more speculative to appraise the proper discounts for the delays, the risks and the liabilities involved than to appraise the shares themselves. And of all possible appraisals that alone was sure to be wrong which the Board chose; a doctrine so enamored of accuracy that it must abdicate is the most irrational of all. The law is not so helpless; situations again and again present themselves where, after all shifts are exhausted, rather than permit certain injustice, a tribunal will make the best reckoning that the facts admit though fully conscious of its infirmities. * * *

Randolph E. Paul, in his work on Federal Estate and Gift Taxation, Vol. II, expresses similar thought (pp. 1217-23):

“Value is essentially and peculiarly a difficult question of fact, with the burden of proof upon the taxpayer. Indeed, it is in one sense even more than a question of fact; it is a question of prophecy, a matter of opinion and judgment. It has even been said that valuations are of the stuff that dreams are made of. Thus, the value of property is hardly even a simple question, even when market quotations are available as a criterion. It is unsafe to neglect any apparent factor. And it is the composite of all factors involved in a single case that

should lead to a conclusion rather than an impractical attempt to assign to any particular factor a precise weight or to define its relative emphasis or importance in a total equation of valuation. Individualized treatment of each problem is essential. The variety of things affecting value cannot be counted by any available mathematics; we soon reach 'potent imponderables.' The cases are recalcitrant. They vary without rules of variation. Market value 'is so dependent upon time, places, conditions, and people that that which is a good rule in one case may be no rule under other circumstances.' One case requires the valuation of real estate, another a remainder interest in personalty. Another case has its penumbræ [64] of stock market operations. We are driven from an almost nostalgic desire for simplicity and certainty to a realistic conclusion that 'no cut and dried formula,' or definite circumscribed method or rule, will do the job for all cases. Courts must do as well as they can with a 'composite mass' of evidence, 'giving judicial consideration to the evidence properly in the record.'

The problem goes deeper than the variability of subjects of valuation. Subjects of valuation may on occasion be static; the inventory of properties calling for valuation is in large part composed of the things our grandfathers possessed. But value, in the very nature of things, is in constant flux; a transverse time factor complicates the problem and awkwardly poses the question of date of valuation. Dates are important, even crucial, in a chang-

ing mid-twentieth century world. One date means one thing, another date another thing, in the shifting—indeed, the chaotic—economic world from which valuation evidence must be taken. The job of the valuation expert, or tribunal charged with a duty to value, is to find the resultant of many conflicting forces. It must do the best it can with an imperfect record, and with a faulty perception, because in the law the courts must strive toward answers that will do. The thing must be decided. [65]

* * * Attempted perfectionism would paralyze ‘the function of deciding,’ and a refusal to exercise judgment would be an error of law. The courts may not shirk their duty of deciding because it is difficult to get competent evidence. Where there are no fields of black and white, formalistic mathematical accuracy would be ‘delusive exactness.’ One must not be ‘enamored’ of accuracy, for the best valuation is nothing better than a reasonable approximation reach by the *via media* of compromise and reconciliation of many practical and logically conflicting pressures and shades of contradiction. Syllogistic logic is too simple a tool. Something less artificial, some quality of discretion, something like common sense, a process of inarticulate and unconscious judgment, is needed. The factor of intuition must and does join forces in reaching an answer that is then dressed in legalistic language and in formally stated principles of valuation.”

IV.

Aside from speculative and argumentative factors,

however, there are a few facts which demonstrate that there is no credible evidence to support a value of \$900.00 and hence the report is legally insupportable.

(1) Tax cases must be decided upon the record made at the hearing, particularly where the [66] Judge who heard the case has since resigned and the case is decided by a new Judge. Expert testimony cannot be arbitrarily disregarded. Yet the present report, without a word of justification, rejects the testimony of six experts on the question of the value of the stocks—five presented by petitioners and one by respondent.

Counsel have never seen a case where a value was found more favorably to a party than was testified to by his own expert witnesses. Yet in the present report of a value of \$900.00 per share is found notwithstanding that two of the three experts called by respondent expressed opinions lower than that figure. One of respondent's witnesses (Mr. Phillips) expressed an opinion of \$759.00 per share; and even this opinion was based upon an erroneous and inflated value for the oil.

(2) There was a tremendous difference between the value determined by respondent (\$950.00) and the value contended for by petitioners (\$400.00). The respondent sought to defend his value upon the bare legal argument, which he frankly admits on brief, that it is permissible to value the stock by dividing the asset value by the number of shares outstanding, citing a few cases where this has been

done involving very closely-held, non-operating companies organized in the main for tax avoidance purposes. [67]

The petitioners joined issue with such a revolutionary principle and contended that it would be error as a matter of law in the case of an operating company, the control of which is divided between two large families of first, second and third cousins and with the balance of power in a disinterested trustee, to value the stock by simply dividing the assets by the number of shares.

No one reading the present report could even surmise that such an issue had been presented for decision. It is not mentioned. But the finding is a tacit approval of respondent's contention, for the value found is within \$3.00 of the amount derived by dividing the fair market value of the assets as determined in the report by the number of shares outstanding (\$902.91).

(3) The concluding paragraph of the report states that consideration had been given to past and future earnings. No mention is made in the findings or the opinion that current earnings were only \$48.00 per share. There is no finding and no comment upon uncontradicted evidence presented by petitioners, based upon stipulated future income from oil, that earnings for the next ten years after depletion would be less than \$30.00 per share. No sufficient reasons are given in the report to justify a value nearly 20 times current earnings and 30 times prospective earnings. [68]

(4) A fact that was testified to by six witnesses, including one of respondent's own witnesses, is that on the basic date the stocks of the very best companies were selling at substantial discounts from the fair market value of their underlying assets. This was no "speculative" or "argumentative" factor, but a fact agreed upon by witnesses on each side. The report does not even mention this fact and in effect ignores it by valuing the stock at the value of the underlying assets.

(5) The report states that the evidence has been analyzed under the heads of (a) petitioners' witnesses, (b) respondent's witnesses, (c) intra-family sales, and (d) appraised value by companies and officers. They cannot support a value of \$900.00 per share.

(a) The report obviously rejects the opinions of petitioners' five witnesses, for their values ranged from \$304.00 to \$420.00 per share, the highest less than one-half the value determined in the report.

(b) The opinions of two of respondent's three expert witnesses fail to support the value found in the report, for they were both lower. One was \$759.00 per share and the other \$861.46. Respondent's other witness, who was the only one of eight witnesses called [69] by either party who valued the stock as high as that found in the report, was Mr. Grimes, an employee of the Bureau of Internal Revenue, who had no familiarity with stock market conditions at June 5, 1941 [T. 639], and who admitted on the witness stand that he valued the

stock solely by dividing the value of the assets by the number of shares outstanding. On page 674 of the transcript:

“Q. * * * did I understand you to say that it was your opinion that the value per share of the Dominguez is equivalent to the fair market value of the total assets divided by the total number of shares outstanding?

A. That is right.”

In the recent case of *Richardson v. Commissioner* (C. C. A.—2), 151 F. (2d) 102, 105, the Court stated:

“To me, at least, the findings and opinion when read together strongly suggest that the valuation adopted was based upon some such theory as was enunciated by the respondent’s experts whereby the controlling criterion of value for stock such as this was taken to be not its fair market value as provided in the applicable regulations of the Treasury Department but rather some notion of ‘intrinsic’ value. If so, the holding was erroneous. [Citing several cases.]” [70]

(c) The report gives none of the facts surrounding the so-called “interfamily sales” which demonstrate that they were not representative sales and that they have no bearing upon fair market value.

1. The only sales of any of the stocks of the three companies for cash from October 3, 1936 to June 5, 1941, or for nearly five

years prior to the basic date, were two shares of Dominguez which were sold by a Watson to his brother for \$700.00 per share, and 88 shares of Carson for \$300.00 per share, six of said shares being purchased from outside interests. Yet the report finds a value of \$900.00 for Dominguez stock and \$500.00 for Carson stock. It is perfectly obvious that these sales do not support the values found, and yet, of the few intra-family transactions that took place in five years, they are the only ones which had the remotest element of a bargain and sale in that cash actually changed hands.

2. The only other sales of Dominguez stock in the same period were two sales by mothers to their children, involving 99 shares each, at figures which represented the income tax cost bases of the mothers and these figures were used because it was desired to show neither gain nor loss inasmuch as losses could not be deducted on such [71] transactions. The consideration for such shares were long-term non-interest bearing notes of the children which were intended to be paid out of future dividends on the stock. It is an error of fact and law to rely upon such transactions as reflecting fair market value.

3. There were no sales of Carson stock during the same period except the two sales in 1935 and 1936 for \$300.00 referred to hereinabove. A value of \$300.00 in 1936 supports

petitioners' contention that the value did not exceed \$230.00 per share on June 5, 1941, for the oil properties of Dominguez had been depleted by more than \$6,000,000.00 in royalties from 1936 to 1941. Certainly there is nothing to support a value of \$500.00 in 1941.

4. There was no sales of Francis stock in the same period except two sales by mothers to their children under exactly the same circumstances as set forth in "2." above.

(d) "Intercompany ratings" are also said to have been considered in the report, consisting of four items. Three of them are the figures at which Dominguez and Francis shares were carried on the books of other companies; in other words, book value. How [72] utterly worthless they are in determining fair market value is shown by the fact that shares of Dominguez were carried on the books of Francis at \$1,019.00 per share, while at the same date the Dominguez shares owned by Carson were carried on its books at \$722.00 per share. And at the same time Francis stock was carried on Carson's books at \$1,137.00 per share, although no one has ever contended that Francis stock is more valuable than 1.1 times that of Dominguez per share. Book values are notoriously unreliable in ascertaining fair market value, as these figures demonstrate, and are wholly irrelevant in a case where a tremendous amount of evidence has been introduced to prove the fair market value.

The other so-called "intercompany rating" is said

to be the official report of Dominguez to its stockholders in 1941, stating that the appraised value of the stock of Dominguez was \$1,000.00 per share.

We will pass the point that the statement referred to was made in a report dated March 28, 1940 [Ex. C. C.], covering the year 1939, instead of in the year 1941. In view of the weight apparently accorded this fact by Judge Harlan it is important to review the statements [73] made by Judge Mellott when counsel for respondent offered it [see T. 499]:

“The Court: Well, you have hardly answered the question. You are valuing, or we are attempting to value, in this case the stock of this company as of June 5, 1941. Now, as to a value placed upon the stock by officers of the corporation at some earlier date, it would probably be hearsay and be mere speculation or opinion of the officers. They may have been entirely too optimistic or they may have been entirely too pessimistic. I fail to see where it has a great deal of materiality, assuming that there is any competency at all, although I am reluctant to exclude it from evidence if you think there is some real connection that can be made.”

Thus, the Judge who heard the case considered this evidence as probably hearsay, of no great materiality, if competent at all, and as mere speculation on the part of an officer.

Furthermore, the opinion overlooks the explanation of Mr. Cotton, the president of the company

and author of the statement, who testified under other oath [T. 742] that prior to the present suit there had been no appraisal of the Dominguez stock; that his use of the words "appraised value" was unfortunate since he was referring to "the figure that was set forth by [74] the Government in their claim for taxes in the Francis estate and on which tax was paid." That was in 1934.

To substantiate the fact that there had been no appraisal made, counsel for respondent read into the record a resolution adopted by the board of directors of Dominguez on August 13, 1941 (after our basic date), as follows [T. 494-6]:

"The chairman, Mr. H. H. Cotton, then brought up the matter of an appraisal on the Dominguez Estate Company stock, stating that in his opinion he felt that an appraisal of the assets should be made of the Dominguez Estate Company to determine the present value of its stock. * * *"

Thus, the uncontradicted evidence in this record proves that the appraised value relied upon in the report was nothing more than a figure adopted by the Commission himself in 1934, seven years before the gifts in our case. And that Mr. Cotton did not acquiesce in that exorbitant figure even in 1934 (and it should be remembered that more than \$6,000,000.00 in oil royalties were received between 1934 and 1941, thereby depleting the company's assets to that extent) is shown in the report of

the same Mr. Cotton to the stockholders in 1937, where he stated:

“* * * It seems that it should be the policy of this company to dispose of as [75] rapidly as possible a large percentage of these unproductive lands both from the standpoint of Dominguez Estate Company as a corporation, but more from the point of the stockholders of this corporation because, as was exemplified in the Estate of Mrs. Francis, the values of the stock of this company are predicated on the values of the land as assessed by Government employees, and the value of the stock of Mrs. Francis was increased a tremendous extent by valuations that surely did not exist and many hundreds of thousands of dollars were paid in inheritance taxes.”

This was in keeping with action taken by Mr. Cotton upon another occasion, in May 1936, showing that he certainly did not believe the stock was worth \$1,000.00 even at that early date. Counsel for respondent proved that another Company had offered to sell Dominguez 980 shares of Dominguez stock at \$800.00 per share. This offer was not accepted and Mr. Cotton explained why on page 741 of the transcript:

“Because I advised the directors that the price was way out of line and too high. At the same time the directors authorized me to negotiate with the Del Amos as to the price of the stock. After talking it over with Mr. Del

Amo, he finally withdrew his offer to sell.” [76]

Hence, in giving weight to the so-called appraised value of the board of directors the report relies upon incompetent speculation which is full explained in the record as being entitled to no credence whatever.

These, then, are the four headings under which the report analyzed the evidence. We ask in all sincerity: Is there any sound justification whatever in all the above for the values determined in the report?

V.

In view of the foregoing it is respectfully submitted that there is not one reason given in the report to justify the values found therein and that, on the contrary, the report shows on its face that there is no credible evidence to support it. Petitioners believe that the proceedings should be reviewed by the full Court and reconsidered in the light of the foregoing.

A. CALDER MACKAY,
ARTHUR MCGREGOR,
HOWARD W. REYNOLDS,
ADAM Y. BENNION,
Counsel for Petitioners,

HUGH G. ARNOLD,
Of Counsel.

[Title of Tax Court and Cause.]

ORDER

The motion of the petitioner filed on August 19, 1946, asking for review by the full Court of the Memorandum Findings of Fact and Opinion of Division 11 (Harlan), is hereby denied.

/s/ J. E. MURDOCK,

Acting Presiding Judge.

Dated : Washington, D. C., August 21, 1946. [78]

[Title of Tax Court and Cause.]

DECISION

Pursuant to the memorandum findings of fact and opinion entered herein on July 22, 1946, directing that decision be entered under Rule 50, the respondent, on October 18, 1946, filed his computation for entry of decision and petitioner, on October 31, 1946, filed an acquiescence therein. It is therefore

Ordered and Decided: That there is a deficiency in gift tax herein for the year 1941 in the amount of \$5,214.00.

/s/ WILLIAM W. ARNOLD,

Judge.

Entered Nov. 12, 1946.

[Title of Tax Court and Cause.]

(Met pursuant to notice.)

Before:

Honorable Arthur J. Mellott, Judge.

Appearances:

A. Calder Mackay, Esq.; Adam Y. Bennion, Esq., 728 Pacific Mutual Building, Los Angeles, California. and Hugh G. Arnold, Esq., 631 South Spring Street, Los Angeles, California, appearing on behalf of Victoria L. Cotton and Virginia Caldwell, petitioners.

H. A. Melville, Esq., (Honorable J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue), appearing on behalf of the Commissioner of Internal Revenue, Respondent. [82]

PROCEEDINGS

The Clerk: Docket No. 2257, Victoria L. Cotton and Docket No. 7583, Virginia Caldwell.

Mr. Mackay: Petitioner is ready.

Mr. Melville: Respondent is ready.

The Court: Will you state your appearances for the record?

Mr. Mackay: A Calder Mackay and Adam Y. Bennion for the Petitioners.

Mr. Melville: H. A. Melville for the Respondent.

The Court: You may state your case for the Petitioners.

OPENING STATEMENT ON BEHALF OF
PETITIONERS

By Mr. Mackay

Mr. Mackay: Your Honor please, in the case of Victoria L. Cotton, Docket No. 2257, the Commissioner determined a deficiency in gift tax for the year 1941 in the sum of \$7,845.75.

The gifts in question were made by Petitioner on June 9, 1941, and consisted of 200 shares of stock of a company known as Carson Estate Company. 100 shares were given to each of two donees.

The only question at issue here concerns the fair market value of these shares of stock. There is no dispute over a credit that was also given to the donees by the donor [83] on May 31, 1941, as set forth in the petition and admitted in the answer.

In her 1941 gift tax return the Petitioner reported the gifts of the 200 shares of Carson stock at a value of \$250.00 per share, a total of \$50,000.00; and in her petition has alleged that the value did not exceed \$175.00 per share, or a total of \$35,000.00.

The Respondent has determined in the notice of deficiency that said 200 shares of Carson Estate Company stock had a value on the date of gift of \$600.00 per share, or a total of \$120,000.00.

Through extended conferences, the parties have attempted to agree upon as many of the basic facts as possible. A stipulation will be presented, to which are attached Joint Exhibits numbered from 1-A to 20-T.

The factual situation is rather complex and, since

most of the factual background is reflected in the stipulation, it will assist the Court to explain at the offset what the parties have stipulated.

We are concerned here with the stock of three companies and with some oil properties. The reason for this is as follows:

The Carson Estate Company owns about four oil properties. It also owns, among its principal assets, 1,785 shares of stock of Francis Land Company (out of a total of [84] 5,000 shares outstanding). The parties have been unable to agree upon the value of the stock of the Francis Land Company or of the oil properties owned by Carson.

The principal asset of Francis Land Company is a controlling interest in another company, the Dominguez Estate Company. Francis owns 5,499 shares of the outstanding 10,499 shares of Dominguez Estate Company. The parties have been unable to agree upon the value of the Dominguez Estate Company shares.

The principal assets of the Dominguez Estate Company consists of oil properties, namely, a landowner's royalty interest in approximately 13 oil leases.

The parties have prepared a chart showing the relationship of these three corporation, their total shares outstanding, the number owned by each. This chart is Joint Exhibit 16-P attached to the stipulation. I have in my hand, if your Honor please, an extra copy of that chart and I think it might help your Honor to follow us through this labyrinth of the three corporations.

I may point out the corporations upon the left-hand side have nothing to do with this particular case. We are concerned only with the three companies, the Carson Estate Company, the Francis Land Company and the Dominguez Estate Company.

Dominguez Estate Company owns assets other than [85] the oil royalties, such as stocks, bonds, ranch real estate and city real estate; but the parties have agreed upon and stipulated the fair market value of all such assets as of the date of gift. These stipulated figures for Dominguez are shown in Joint Exhibit 1-A.

In other words, the only assets of Dominguez Estate Company upon which the parties have not agreed as to the value are the oil royalties. Evidence will be presented with respect to the value of such oil royalties.

The parties, however, have presented in the stipulation certain estimates with respect to the oil royalties. In Joint Exhibit 11-K (1) an estimate is shown of the probable future production of barrels of oil from known oil reserves owned by Dominguez Estate Company at the basic date, [86] together with the royalty share of Dominguez Estate Company therein. It will be seen from that exhibit that the total estimated figure for all of Dominguez Estate Company's known reserves is 47,790,000 barrels, and that the royalty share of Dominguez Estate Company therein is 7,992,871 barrels.

Said Joint Exhibit 11-K(1) also gives an estimate of the probable future rate of production of said

oil. I should like to call your Honor's attention, however, to a proviso in the stipulation to the effect that the estimate——

“* * * is based upon the assumption that all wells being produced on June 5, 1941, would continue to be produced to the full indicated capacity of the formation to yield the oil, and, further, that each probable productive location of said known oil reserves would be developed and produced to its full indicated capacity in accord with its probable development program.”

Joint Exhibit 11-K(2) is a computation, using the price of oil during the five months preceding the date of gift, of the probable royalty income to be derived by Dominguez Estate Company based upon the estimated production set forth in the preceding Joint Exhibit 11-K(1).

Here, again, your Honor's attention is directed to the following statement in the stipulation:

“It is understood and agreed that nothing [87] contained in said joint Exhibits 11-K(1) and/or 11-K (2) shall limit either party in presenting evidence with respect to discounts and other factors and/or methods that might be taken into consideration in determining the fair market value of said oil royalties or in presenting any evidence of such fair market value based upon other indices.”

The Court: Will you pardon an interruption?
Off the record.

(Discussion off the record.)

The Court: On the record. You may proceed.

Mr. Mackay: In other words, in an effort to shorten the time of this trial, the attorneys have agreed upon an engineer's estimate of the known oil reserves, probable rate of production at full indicated capacity of the formation to yield the oil, and upon the price of oil current at the basic date, without, however, admitting or agreeing that a willing buyer would have blindly accepted such estimates.

Expert testimony will be offered to show what discounts and factors and what other indices of value would be used by a willing buyer of the oil royalties.

Petitioner believes the evidence will establish [88] that the fair market value of the oil royalties owned by Dominguez Estate Company at June 5, 1941, did not exceed \$3,000,000.00.

In the case of Francis Land Company, Joint Exhibit 2-B shows the assets and liabilities upon the values of which the parties have agreed. Your Honor will note that, aside from the 5,499 shares of Dominguez Estate Company stock owned by Francis Land Company, all of the other assets of Francis Land Company had a value of only \$83,000.00, and that its liabilities were \$85,000.00. Francis Land Company owned no oil properties. It therefore is clear that the only asset of Francis Land Company of

any consequence here—and the only one upon which the parties have not stipulated a value—is its controlling interest of 5,499 shares in Dominguez Estate Company.

Joint Exhibit 3-C is a similar statement for Carson Estate Company. Carson owned, as heretofore stated, a few oil royalties—landowner's royalties, as in the case of Dominguez Estate Company. Joint Exhibits 12-L(1) and 12-L(2) give similar estimates with respect to the oil properties as in the case of Dominguez Estate Company, and are similarly limited in scope. They reveal that the probable future barrels of production are 2,590,000 barrels, and that Carson Estate Company's royalty interest is 398,796 barrels.

Other assets of Carson Estate Company, as shown on [89] Joint Exhibit 3-C, are the 1,785 shares of Francis Land Company stock and 1,353 shares of Dominguez Estate Company stock, the values of which are at issue; and its other assets—securities, ranch real estate and other real estate—are shown at stipulated fair market values as of June 5, 1941.

In other words, the parties have agreed upon the fair market values of all assets involved in this proceeding except:

- (1) The oil properties and the stock of Dominguez Estate Company;
- (2) The stock of Francis Land Company;
- (3) The oil properties and stock of Carson Estate Company.

Various other facts have been agreed upon and are included in the joint exhibits.

4-D, 5-E, and 6-F show the earnings and dividends paid by the three companies, respectively, from 1927 through May 31, 1941. The parties have stipulated that said earnings up to December 31, 1940 are the correct earnings without taking into account percentage depletion, except for cost depletion as shown on said exhibits.

Since the companies are on the cash basis, the earnings shown on said exhibits for the five months in 1941 preceding the date of gift do not necessarily give a true [90] picture of the earnings for that period, and consequently another exhibit for each company, 4-D(1), 5-E(1), and 6-F(1), have been stipulated, showing the earnings for the entire year 1941 and 5/12ths thereof.

Joint Exhibits 7-G through 10-J show approximate allocations, so far as possible, of general and administrative expenses and earned surplus adjustments for Dominguez Estate Company and Carson Estate Company.

Joint Exhibits 13-M through 15-O are lists of the stockholders of the three corporations as of June 4, 1941.

I might state at this point that all of the companies are personal holding companies.

Joint Exhibit 16-P is the chart, a copy of which has heretofore been handed to your Honor, and the last four exhibits 17-Q through 20-T, are maps of the oil properties of Dominguez Estate Company and Carson Estate Company. We have extra copies of said maps which it may be well to refer to during the trial.

The parties have stipulated that figures as of May 31, 1941, may be taken to be the figures as of the date of gift five days later.

In the case of Virginia Caldwell, Docket No. 7583, the petitioner, on August 11, 1941, made gifts of 100 shares of Dominguez Estate Company stock and 105 shares of Francis Land Company stock. The only issue in that proceeding is [91] over the fair market value of said shares, the Commissioner having determined a deficiency in gift tax of \$18,641.51.

In her gift tax return for 1941 petitioner reported the 100 shares of Dominguez Estate Company stock at \$340.00 per share, or a total of \$34,000.00. The Commissioner determined the value to be \$950.00 per share, or a total of \$95,000.00.

Petitioner reported the value of the Francis Land Company stock at \$374.00 per share, or a total of \$39,270.00 for the 105 shares. The Commissioner determined a value of \$1,045.00 per share, or a total of \$109,725.00.

The valuation date in the Caldwell case is so close to that in the Cotton case—August 11 and June 5,—barely more than two months—that the parties feel a long trial in each proceeding would be unwarranted and an imposition upon the court.

The evidence will show, if your Honor please, that the values of each of the three stocks involved here were dependent in large measure upon the oil properties of Dominguez Estate Company and that the latter of course are wasting assets. It will also show that they were at the peak of production just

prior to the basic date and that the operation is in substance a liquidating affair. That is to say, the Dominguez Estate Company is not an oil company out in the market buying other oil fields with the idea of continuing in [92] the oil business indefinitely.

It will also be shown, if your Honor please, that the general investment market at June 5, 1941, was very unsettled and that good stocks actively traded in were selling at comparatively low figures. It will also be shown that investors are extremely hesitant to buy stock—particularly minority stock, as we have here—in closely held family personal holding companies. The evidence will show that these companies were caught in a strangling tax-squeeze, so to speak, brought about as your Honor knows, by the enactment of the personal holding company surtax. In other words, these companies are bound to be liquidating affairs for they must distribute all their earnings each year or leave them to the government in surtaxes.

If your Honor please, I apologize to my associate, Mr. Arnold, certified public accountant, associated in this case. I would like to enter his appearance. Mr. Hugh G. Arnold.

The Court: He is admitted to practice before the court?

Mr. Mackay: Yes. I would like to offer a stipulation.

Mr. Melville: May I make an opening statement, if you are through?

Mr. Mackay: I am sorry. [93]

OPENING STATEMENT ON BEHALF
OF RESPONDENT

By Mr. Melville

Mr. Melville: I think Mr. Mackay made a very excellent opening statement and has outlined to the court the issues and problems involved.

As far as the respondent is concerned I will limit mine to simply stating that probably the first decision the court will have to reach is the value of the oil royalties in the Dominguez Estate Company. As to those the government contends they are worth between \$450,000.00 and \$500,000.00.

Mr. Mackay: Stipulate that.

Mr. Melville: \$4,500,000.00 to \$5,000,000.00. Having reached whatever decision the court does with respect to the value of those oil royalties, the court will then have before it the value of all underlying assets, as well as earnings, dividends, and other factors on which to base an opinion as to the value of the stock of the Dominguez Estate Company.

As to the value of the stock of Dominguez Estate Company respondent believes that the evidence will show that that value is at least in the amount set forth in the statutory notice, or \$950.00.

Going then to the second company, the Francis Land Company, each share of stock in the Francis Land Company is represented by 1.1 shares of stock in Dominguez Estate [94] Company. The respondent, therefore, contends that the value of the stock in Francis Land Company is worth at least \$1.045.00.

Going then to the third corporation, the only underlying factors which the court might want to consider in arriving at an opinion as to the value of the Carson Estate Company stock, which is not already agreed to, is the value of the oil royalties. As to those the government believes the evidence will show a value of from \$275,000.00 to \$300,000.00.

Having arrived at such value as the court thinks proper for those oil royalties, it then has all the factors including the value of the underlying assets, earnings, dividends, so forth, on which to reach a value as to the stock of the Carson Estate Company. And as to that stock the respondent believes the evidence will show the value was at least \$600.00, which was used in the issuance of the statutory notice.

Mr. Mackay: Your Honor please, I would now like to make a formal offer of the stipulations and exhibits. You have them, I think, your Honor.

The Court: Very well.

The stipulation of facts, to which has been attached the exhibits referred to, numbered and lettered as counsel indicated, may be handed to the clerk and will be filed and [95] constitute a part of the record in this proceeding.

Mr. Mackay: I should like to offer here a stipulation signed by both parties for consolidation of these two cases.

The Court: Very well. Thank you, gentlemen. The stipulation may be filed in each of the cases.

Off the record.

(Discussion off the record.)

The Court: On the record.

Mr. Melville: I might point out at this time, your Honor, there has been a very slight error in three exhibits, but we will explain that to the court by stipulation perhaps tomorrow.

The Court: Off the record.

(Discussion off the record.)

The Court: On the record.

Mr. Mackay: I will call Mr. Wents.

EVIDENCE ON BEHALF OF PETITIONESS

Thereupon, the petitioners, to maintain the averments of their petitions, introduced the following proof:

JOHN H. WENTS, JR.,

called as a witness for and on behalf of the Petitioners, having been first duly sworn, was examined and testified as follows:

The Clerk: State your name for the record.

The Witness: John H. Wents, Jr. [96]

Direct Examination

By Mr. Mackay:

Q. Mr. Wents, are you a resident of Los Angeles? A. I am.

Q. You have been for some time?

A. I have.

(Testimony of John H. Wents, Jr.)

Q. How long?

A. The greater part of 19 or 20 years.

Q. Will you please tell the court your occupation?

A. I am a consulting geologist and engineer.

Q. How long have you been a consulting geologist and engineer?

A. Since 1939.

Q. 1939?

A. Yes.

Q. What are your educational qualifications?

A. I attended Stanford University during the years 1923-1927. I attended the University of Southern California between the years 1934 and 1939.

Q. Did you get a degree in engineering?

A. No, I did not.

Q. By whom are you employed now?

A. I am employed by myself as a consultant.

Q. As a consultant?

A. As a consultant. [97]

Q. What has your experience as a consultant been?

A. My experience as a consultant has been I went into the business in 1939. At that time I was employed by the Dominguez Estate Company, the Carson Estate Company and the Watson Land Company. Since that time I have been employed by J. Paul Getty, Harold C. Morton, C. H. Lebow and George A. McNee, George D. Nordenholt, Kohlbush & Morton, Miller & Miller, Royal Petroleum Company, Pacific American Oil Company, Sierra Oil Company, St. Francis Oil Company, H.

(Testimony of John H. Wents, Jr.)

M. Halloway, MacMillan Oil Company, George Machris (Wilshire Oil Company), Pettyjohn Drilling Company, Pacific Western Oil Company, George F. Getty, Inc., and by a number of banks, including the Corn Exchange Bank, New York.

Q. In a general way, can you tell us the scope of your activities as consulting engineer and geologist?

A. These are quite broad. As a geologist I examine and report upon potential oil properties, either improved or undeveloped or developed, semi-improved. As an engineer I oversee, superintend and plan initial development of oil properties, their production and development after the oil has been discovered and attend to many and varied details with respect to them.

I have been employed in many instances as an appraiser of oil properties and mining properties. Included in that work I have done the work for the various banks. And during the last three or four years I have been consulted and [98] employed on nearly every case that has come before the Lands Division of the Department of Justice?

Q. To determine what?

A. The fair market value of various oil and gas and mineral properties.

Q. That were taken over by the government?

A. In the process of their condemnation, yes.

Q. In that work have you had occasion to make valuation of oil royalties on oil properties?

A. In my employment, prior to the time I went

(Testimony of John H. Wents, Jr.)

into the consulting business for myself, I was employed as chief geologist and appraiser for Diversified Royalties, Ltd.

Q. When was that? A. 1934 to 1939.

Q. What were your duties there?

A. To appraise oil royalty interests that were offered to that company for purchase.

Q. What was the nature of that company's business? A. Dealers in oil royalties.

Q. Buying and selling oil royalties?

A. Buying and selling oil royalties.

Q. Did you act as consultant there in determining values?

A. I appraised many million dollars of royalties.

Q. Oil royalties? [99]

A. Oil royalties; in that capacity.

Q. Mostly, I suppose, in Southern California?

A. Yes, in Southern California. Probably two-thirds of the interests involved in production in Southern California. The other one-third in production in other fields in California.

Q. In your appraisal work there did you value the oil royalties so far as the land owner interest was concerned?

A. Many landowner royalty interests.

Q. Have you ever bought and sold oil royalties yourself? A. Only in a minor way.

Q. Have you been employed by the banks and financial institutions to appraise oil royalties or oil properties? A. Yes, I have.

Q. To what extent?

(Testimony of John H. Wents, Jr.)

A. From time to time the banks, including the banks I mentioned, the Corn Exchange and Chase National Bank, have called upon me to voice my opinion with respect to the fair market value of various oil royalty interests which have appeared in the estates and what not, and in which the bank has acted upon.

Q. You speak of the Corn Exchange Bank and Chase National. They are in New York?

A. New York banks. Local banks would include the Bank of America, the Security-First National Bank, the California [100] Bank; probably most of them.

Q. What other experiences have you had in valuations?

A. When I finished Stanford University in 1927 I went to work for the Marland Oil Company in the valuation and research department, at which time I was directly under the employ of Carl Beal. I remained in that employ until 1929; during which time I worked on many valuation problems.

In 1929 I went to work for the Associated Oil Company in the petroleum engineering division. I was transferred to the geological department, and for four years was resident geologist and engineer in the central-coastal area, during which time I had occasion to appraise properties in the light of desirability of selling or purchasing for the account of the Associated Oil Company.

Q. Have you any further things you want to mention with respect to qualifications?

(Testimony of John H. Wents, Jr.)

A. I probably have missed a number of my employers in the past.

Q. Now, Mr. Wents, since 1939 have you been employed by the Dominguez Estate Company and the Carson Estate Company? A. Yes, I have.

Q. Tell the court just what your duties have been there with respect to them?

A. Dominguez Estate Company and the Carson Estate Company own some very important oil and gas lands here in [101] Southern California. They saw fit to employ me to look after their interests, they being the landowner. And in that instance in the course of that employment I have made careful observations and studies of the production of the wells which had been drilled upon the property previous to the date of my employment, those wells which have been drilled since the date of my employment, and all production to date of the individual wells of each of the leases. I have reported on various phases of reservoir performance. I have outlined to my employers at their request certain practices which should be called to the attention of the operating company, with respect to the future operation or the operation as of a date, of the properties, and in a general way just interpreted the leases and followed through and watched over the production and development.

Q. You are familiar with the production from the wells, are you, since 1938? A. I am.

Q. Including 1938? A. I am.

Q. And even prior?

(Testimony of John H. Wents, Jr.)

A. Oh, yes; from the inception of production on the individual wells.

Q. Now, will you please tell the court how many leases or where the land is located? I mean the Dominguez Estate [102] Company. Have you a map, Mr. Wents?

A. I have a number of maps. It takes three maps or four maps really to show the location of these lands.

Q. Could you get them on this board some way?

A. I could if I had some thumb tacks.

The Court: Off the record.

(Discussion off the record.)

The Court: On the record.

By Mr. Mackay:

Q. Now, Mr. Wents, is that a map of the oil properties of the Dominguez Estate Company?

A. That is a map of the Dominguez oil field.

Q. Of the field?

A. Upon which are shown certain of the leases of the Dominguez Estate Company, as well as other leases.

Q. How many leases did Dominguez have on its lands?

A. There are 13 separate operators and properties involved.

Q. In other words, 13 separate leases?

A. There may be a couple more leases, because we have moved them in certain instances here (indicating).

Q. At least 13 separate leases?

(Testimony of John H. Wents, Jr.)

A. 13 separate, distinct properties, so far as we are concerned.

Q. Can you point those out to the court? [103]

A. With respect to those on Dominguez Hill I can. The Shell Company—

Q. Do you have a red pencil you can mark that?

The Court: Off the record.

(Discussion off the record.)

The Court: On the record.

By Mr. Mackay:

Q. Well now, Mr. Wents, referring to Joint Exhibit 17-Q, copy of which you have in your hand, and the court has and counsel has, will you explain to the court where the land of the Dominguez Estate Company is located?

A. The land of the Dominguez Estate Company upon Joint Exhibit 17-Q has been outlined in red. Land which is jointly owned or on a joint lessorship by Dominguez and Carson Estate Companies is shown cross-hatched in blue and red.

Q. Is that on the same exhibit? A. Yes.

Q. What do you mean by "cross-hatched"?

A. Cross-hatched, diagonal lines across the parcel.

Q. I see. That one large piece there in red, is that known as the Reyes lease?

A. The large central piece shown on the map is the Reyes lease.

Q. There is one there, the Tidewater Associated Oil [104] Company, DeFrancis lease. Is that owned by Dominguez lease?

(Testimony of John H. Wents, Jr.)

A. That is owned by the Dominguez Estate. We refer to it as the DeFrancis.

Q. The Shell-Manuel, is that the name of a lease?

A. The Shell-Manuel is owned by the Dominguez Estate Company.

Q. There are only three leases shown on this?

A. No. In the lower right-hand corner of the map is a lease we refer to as the Shelbar lease. That lease is a hundred-plus or minus acres.

To the left of that particular lease, in the lower part of the map, is the lease we refer to as United Oil Well Supply.

Q. Is that marked on there?

A. Only as a designation over the well.

The Court: It is only marked 46-plus acres; is that right?

The Witness: 46-plus acres is the size of that particular lease. Above the central or Reyes lease, up in the lower left-hand corner of a property marked as Carpenter, is a piece of property two acres in extent, in which the royalty is shared between the Dominguez and Carson Estate Companies.

By Mr. Mackay:

Q. On an equal basis? [105]

A. No, it is not upon an equal basis. One-ninth of the royalty is payable to the Dominguez Estate Company. One-eighth is payable to the Carson Estate Company.

Q. What other oil property has the Dominguez Company under lease?

A. On the map, designated as Joint Exhibit

(Testimony of John H. Wents, Jr.)

18-R—that is the next map in the series—there are five properties outlined in red. Commencing with the upper left-hand one, those leases are designated as the Wood-Callahan Oil Company. That property is owned by Dominguez Estate Company and the lease covers 140-plus or minus to that acres.

To the east of that, or left of that, is the lease we designate J. E. Pettijohn-Jergins Oil Company lease. That property is owned by Dominguez Estate Company and consists of 345 acres.

Then over still further to the east is a little property of eight-plus or minus acres, which is operated by the C.C.M.O. Oil Company.

Q. Who is the C.C.M.O.?

A. Chanslor-Canfield-Midway Oil Company.

Then moving across to the west again we have two properties over there. The Royal Petroleum Company lease, consisting of 114 acres, owned by Dominguez Estate Company, and the George F. Getty, Inc., 15 acres less.

Now, in reference to that latter property we [106] sometimes use the designation Standard-Getty lease because of the fact our royalty has been paid by the Standard Oil Company in the past.

Now, Joint Exhibit 19-S shows a single property, Dominguez Estate property, in the very central portion of the map area. That property consists of one city block, about 4.5 acres, and is operated by the Holly Development Company.

Now, Joint Exhibit 20-T. In this instance the Carson Estate Company and Dominguez Estate

(Testimony of John H. Wents, Jr.)

Company entered into a community lease for the development of approximately 300 acres of land; I mean as of this date. That 300 acres of land is shown on Joint Exhibit 20-T. The operator of the major portion of these lands is the Hilldon Oil Company. In the central portion of the Hilldon lease is a lease we designated here as the Victory Oil Company lease. They are the operators. The Dominguez and Carson Estate Companies are the landowners. The split between the two landowners is slightly in the favor of the Carson Estate Company by less than a half a per cent.

Q. Is that all the oil properties of the Dominguez Estate Company?

A. Yes, they are. They do happen to be shown on these maps. Also, the properties of the Carson Estate Company, but they are separately designated.

Q. Can you point out to the court what properties of [107] the Carson Estate are listed?

A. On Joint Exhibit 17-Q the property lying in the central left-hand portion of the map, Union Oil Company of California, Dominguez Oil Fields Company, Carson lease. That property of 349-plus or minus acres is owned by the Carson Estate Company.

As pointed out, the Carson Estate Company has an interest in the oil produced from the two acres of the Carpenter lease.

The Court: Are all these one-sixth interest royalties? Is that what they are?

(Testimony of John H. Wents, Jr.)

By Mr. Mackay:

Q. What are they, Mr. Wents?

A. Your Honor, they are various royalties. We will show in each case what the particular interest is. Generally one-sixth, unless otherwise noted.

Joint Exhibit 18-R, that is the second map of the series, and that would be in the central right-hand portion of the map where there is a small triangular piece of land outlined in blue, approximately five acres in extent, and referred to by us as the Standard-Carson lease.

Q. Is that on Joint Exhibit 18-R?

A. Yes.

Q. I see a three-cornered——

A. A little triangular section. [108]

Q. Section 13?

A. Yes. As explained with reference to Joint Exhibit 20-T——

The Court: You leave out 19-S because there is nothing on it?

The Witness: There is nothing on 19-S owned by the Carson Estate Company.

On Joint Exhibit 20-T I have explained the ownership of the lands there as being vested in both the Dominguez Estate Company and the Carson Estate Company.

The Court: That is all shown in the criss-cross red and blue marks?

The Witness: It is.

By Mr. Mackay:

Q. Mr. Wents, I will ask you if this is the lease

(Testimony of John H. Wents, Jr.)

of the amendments on the Reyes lease you speak about you identified to the court.

A. That is the original lease between the Union Oil Company and the Shell Oil Company with respect to the property we refer to as the Reyes lease.

Q. What is that other document you have in your hand? A. That is an agreement.

Q. This, by the way, is dated 31st day of August, 1923?

A. Yes. That is an agreement which was entered into subsequent to that lease. [109]

Q. That is dated what date?

A. 1936, I believe; August 25, 1936. It is with respect to the Reyes lease.

Q. An amendment?

A. Really it is an amendment to the Reyes lease.

Mr. Mackay: I think these may both be offered as one exhibit.

Mr. Melville: No objection.

The Court: Just a moment. Let's complete these numbered exhibits first. You have used through 20-T; haven't you?

Mr. Mackay: For joint exhibits.

The Court: For joint exhibits.

Mr. Mackay: That is right.

The Court: It may simplify our numbering and help us if we arbitrarily start with Petitioners' Exhibit No. 21 for the next number, and let respondent start with AA for his first number of a separate exhibit.

Mr. Mackay: That is quite all right.

(Testimony of John H. Wents, Jr.)

Mr. Melville: Very well, your Honor.

The Court: We will mark the documents tendered as the Reyes lease as Petitioners' Exhibits 21 and 22, since there are two of them. They are fastened together. Mark them Petitioners' Exhibits 21 and 22. There being no objection, they will be received. [110]

(The leases referred to were marked and received in evidence as Petitioners' Exhibits 21 and 22.)

[Petitioners' Exhibits 21 and 22 set out in full in Book of Exhibits.]

Mr. Mackay: Could I indulge the court and take those tonight and get extra copies photostated to give to my opponent?

The Court: You may do so.

By Mr. Mackay:

Q. Now, Mr. Wents, I think you stated it was your duty to watch the production of the well since you went there and also to study the prior production? A. Yes.

Q. Can you tell what the average daily production was in 1938, 1939, 1940 and 1941, up to the basic date June 5, 1941?

A. I can refer to my records?

Q. Yes.

A. In order that the figures may be understood and may be weighed I have reduced it to royalty barrels in this instance. That gives——

Q. That is all we are interested in, is royalty barrels.

(Testimony of John H. Wents, Jr.)

A. I have started this in—what year do you want, 1930?

Q. 1938. [111]

A. 1938. In 1938 the total royalty barrels was 845,870 barrels to the Dominguez Estate Company.

The Court: Will you pardon the interruption? What does that mean? Does that mean estimated future production or the annual production for that year, or what?

The Witness: That is the annual production translated to royalty barrels from the property, all properties of the Dominguez Estate Company for the year 1938. In other words, in place of taking, say, a blanket one-sixth of the total gross production from all leases, this figure respects the different royalty rates had on the various leases.

The Court: Well, you gentlemen may understand what he means; I am not sure I do.

The Witness: That is the actual barrels of royalty oil.

The Court: That is the number of barrels that if oil had been divided in kind on the basis of, Dominguez Estate would have received that number of barrels?

The Witness: In barrels of oil.

The Court: I see.

The Witness: Yes.

The Court: All right.

Mr. Melville: Could we have that last question and answer, please?

(The record was read.) [112]

(Testimony of John H. Wents, Jr.)

The Witness: The year of 1939, 585,731 barrels.

The year of 1940, 520,448 barrels.

The five months of 1941, 229,159 barrels.

Mr. Mackay: I introduced the leases and amendment in the Reyes lease. I think it is agreeable to counsel that the other leases—we have a great many of them and we don't want to encumber the record—that the other leases are in substantially the same terms as this lease.

Mr. Melville: It may be so stipulated.

The Court: Very well.

By Mr. Mackay:

Q. Now, the Dominguez Estate Company didn't operate any wells; did it?

A. No, they did not.

Q. Approximately how much time have you devoted to Dominguez Estate properties since 1939, and particularly the time between 1939 and June 5, 1941? I will withdraw that.

A. Approximately half——

Q. I beg your pardon?

A. Approximately half my time, I would say, during that period of time.

Q. I see. How often would you visit the field, approximately? A. From three to——

Q. Every day, or every week, or what? [113]

A. From three to five times a week.

Q. From three to five times a week?

A. Yes.

Q. You have done that continuously since you were employed by them?

(Testimony of John H. Wents, Jr.)

A. During certain periods of time it might have dropped down to once or twice a week. Sometimes it has increased to twice a day.

Q. But, in any event, you were there at least several times a week?

A. Yes, I have been.

Q. That is, watching production and watching the wells, looking out for the interests of Dominguez Estate Company?

A. Yes, that is very true.

Q. And the Carson Estate Company?

A. And the Carson Estate Company.

Q. Have you made an appraisal of the oil royalty properties in the Dominguez Estate Company as of June 5, 1941?

A. I have.

Q. Tell the court what the basis has been for your examination and appraisal.

A. The appraisal I made of the oil royalties of the Dominguez Estate Company, as of June 5, 1941, was in the light of certain expected productions from each of the leases, which had been agreed by stipulation. [114]

Q. You are familiar with the stipulation?

A. Yes, I am familiar with it.

Q. You are familiar with the exhibits?

A. Yes, I am. In making this appraisal I followed, to a measure, the so-called analytical appraisal method, inasmuch as rates of production had been agreed upon by stipulation. Annual production for future years were translated to revenue; again on the basis of figures agreed to by stipulation.

(Testimony of John H. Wents, Jr.)

The Court: Let me see if I understand that. I am not trying to cross examine the witness, but I want to see if I understand it.

Mr. Mackay: It is quite all right.

The Court: You have agreed upon a projected estimate as to the production that might reasonably be expected from the different leases; is that what you mean?

Mr. Mackay: Yes, if your Honor please. We were confronted with this. We have agreed, as the stipulation shows, upon the oil reserves, estimated oil reserves at that basic date. And we have gone——

Mr. Melville: No. I believe that has been converted, Mr. Mackay, into probable future royalty income; hasn't it?

The Witness: No.

Mr. Mackay: Let's read the stipulation. [115]

The Court: I didn't mean to interrupt. I was trying to find out if I was following correctly.

Mr. Mackay: You are quite right. I am glad you did. I call your Honor's attention to page 5, paragraph (k) of the stipulation wherein it says:

“Joint Exhibit 11-K(1) is the estimated amount, in barrels of oil, of ultimate probable future production from known oil reserves of all oil properties owned by Dominguez Estate Company on June 5, 1941, together with the royalty share of the Dominguez Estate Company therein.”

And it goes ahead and explains what the estimated probable future production by calendar years is, and so forth.

(Testimony of John H. Wents, Jr.)

The Court: I see.

Mr. Mackay: That agrees upon the estimated oil reserves as therein stated.

“Joint Exhibit 11-K(2) is a computation, based upon said Joint Exhibit 11-K(1) and upon an agreed price per barrel of oil, said price being net revenue per barrels of royalty oil received from January 1 to May 31, [116] 1941. The estimated probable royalty income by calendar years is based upon the assumption that production will be in accord with the rates set forth in Joint Exhibit 11-K(1).”

The Court: That answers my question, I think. I am sorry if I disturbed you by interpolating the question.

The Witness: No.

The Court: You may proceed with your answer, Mr. Wents, if you can.

By Mr. Mackay:

Q. Do you want the reporter to read the last statement? A. Yes, it would help me.

(The answer was read.)

The Witness: Then, in accordance with the method of approach used, I translated annual revenues to the so-called present worth figures. Lastly, I translated present worth to fair market value.

By Mr. Mackay:

Q. Did you make an appraisal of the fair market value of each royalty interest? A. I did.

Q. Will you please state to the court what you

(Testimony of John H. Wents, Jr.)

mean by present worth? You say you made an analytical appraisal and reduced it to present worth. [117]

A. It has been my experience that future revenues or earnings must be translated to present worth before they can be translated to fair market value. Now, I base that entirely upon my experience in many years of dealing and appraising—I base that entirely upon my experience in dealing, buying and selling of oil royalties, and appraisal of oil properties.

Q. Now, what steps did you take to reduce that to present worth?

A. I translated annual incomes, expected annual incomes to present worth, by the use of a 10 per cent discount table or 120 per cent.

Q. Is that typically known as the Hoskhold's Formula?

A. Basically following the Hoskhold's Formula, taking into consideration in this case the income—half the income is had as of the central portion of the year.

Q. Referring to the Reyes lease, what was your present worth figure that you arrived at in your analytical appraisal?

A. The present worth figure which is an only indices of value, in my estimation, is \$4,172,321.00.

Mr. Melville: May I have that again, please?

The Witness: \$4,172,321.00.

By Mr. Mackay:

Q. Well now, after you determined, or after

(Testimony of John H. Wents, Jr.)

making a study of the stipulation and the exhibits, in the light of [118] the knowledge you had of the company and its operations, what did you do after you had computed what you call the present worth?

A. My next step was to reduce the present worth figures to the figure I call fair market value or appraised worth. The two terms being synonymous in this instance.

I have found that by using a discount, the discount being $43\frac{1}{3}$ per cent, with respect to present worth, I arrive at fair market value.

Q. $43\frac{1}{3}$, you say? A. $43\frac{1}{3}$.

Q. Yes.

A. However, I do it the opposite way by multiplying by $56\frac{2}{3}$.

Q. Why do you use that? Why do you discount present worth by that figure to get fair market value?

A. That figure was arrived at from a study of many, many transactions in royalties, landowner royalties and their equivalent of gross overriding royalty, one being basically the same as the other, trading with people who knew what they were trading in, where the sellers were completely familiar with what they were selling and the buyers were familiar with what they were buying, that figure happens to be the mean of the average trading. In other words, the figure which is meant on the street in trading of royalty [119] interests.

Q. You use that same method in valuing the oil

(Testimony of John H. Wents, Jr.)

properties for the government in its condemnation proceedings?

A. When oil royalties are involved, yes, I use exactly the same method.

Q. Will you please explain to the court how you arrived at $43\frac{1}{3}$ per cent?

A. The figure of $43\frac{1}{3}$ per cent was found to be the figure dictated by experience. In other words, in the buying and selling of royalties. The reason why buyers and sellers do not trade on present worth probably is—I should say reasons are manifold, are many.

Q. What are some of the reasons?

A. Likely one of the major reasons is that they are a little bit doubtful regarding the work of us engineers with respect to estimated ultimate production. Generally they are doubtful, with our estimate of rate of production, that is, annual rates of production or the timing of the production.

Then again a buyer wishes to receive more interest on his money and the seller generally has some place to put the money which would be more advantageous than holding it in the royalties.

The many things which would result in the application [120] of this discount and this amount would probably take a long, long time, and I couldn't think of all the reasons why or analyze the reasons why it is applied. It is my experience, my knowledge, it is applied.

The resultant answer after applying this, in this instance, to an appraisal which is figured on the

(Testimony of John H. Wents, Jr.)

basis of a 10 per cent discount factor, this discount only applies in the place of a 10 per cent discount factor, and would reduce that present worth figure, which has been had, to fair market value.

Q. Well, what, in your opinion, was the fair market value on June 5, 1941, of the Dominguez Oil Company interest in the Reyes lease?

A. In the Reyes lease?

Q. Yes.

A. The fair market value of the Dominguez Estate Company Reyes lease was \$2,364,329.00.

Q. Well now, what do you mean by fair market value, Mr. Wents?

A. The price which would be likely to be had from a trade between a willing buyer and a willing seller, both having full knowledge of conditions with respect to the property.

Q. Now, in your experience of valuing oil royalties, what was the name of that company? [121]

A. Diversified Royalties, Ltd.

Q. Had you followed the same method?

A. I followed it the last several years I was employed by them. It took me the greater part of two and a half years to figure it out, and the last two and half years I followed it.

Q. Now, Mr. Wents, referring to the DeFrancis lease, did you follow the same procedure there as you did in the Reyes lease? A. Exactly.

Q. Did you determine the present worth there?

A. Yes.

Q. What was your present worth figure?

(Testimony of John H. Wents, Jr.)

A. My present worth figure is \$192,068.00.

Q. What, in your opinion, was the fair market value on June 5, 1941, of the royalty interest of Francis Land Company in the DeFrancis lease?

A. That is the Dominguez Estate Company.

Q. That should be Dominguez Estate Company?

A. The fair market value of the Dominguez Estate Company, DeFrancis lease, is \$109,349.00 as of June 5, 1941.

The Court: May I ask a question?

Mr. Mackay: Yes.

The Court: Are figures contained in these exhibits that the witness is basing this upon? In other words, [122] do you have your stipulated projected or estimated figures of dollars?

Mr. Mackay: That is right.

The Court: That appears in one of these exhibits?

Mr. Mackay: Yes. That is in Exhibit 11-K(2), I think, your Honor. I will check and see. I think that is it. Your Honor please, -K(1) is the number of barrels.

The Court: Yes.

Mr. Mackay: And then, I think, -K(2) is the dollars.

The Court: I see. Now, you are really talking about what is shown, or he just finished on his two million-odd dollar figure, giving his estimate of the fair market value of the column that is shown there in your sub total of seven million-odd dollars under the Reyes lease?

(Testimony of John H. Wents, Jr.)

The Witness: Yes.

The Court: Now he has gone to the DeFrancis lease?

The Witness: Yes. In that instance, your Honor, we have not recited so far in this testimony the royalty dollars which might accrue in the ultimacy. We have just gone to present worth and appraised worth, is what we have done. Those figures having been derived, however, from the application of the discount factors to the figures which sum to this \$7,790,000.00——

The Court: In a general way what you do is you [123] take, for instance, in this DeFrancis lease, you take \$292,000.00 and you reduce that to present worth by 10 per cent discount formula?

The Witness: That is correct.

The Court: Which gives, you say, in the neighborhood of \$170,000.00?

The Witness: \$192,968.00 in that case.

The Court: Then you reduce?

The Witness: To fair market value.

The Court: By multiplying it by $56\frac{2}{3}$, or the same as reducing it $43\frac{1}{3}$ per cent?

The Witness: That is correct.

The Court: That give you what figure?

The Witness: \$109,349.00.

The Court: I see. Thank you.

By Mr. Mackay:

Q. Well now, turning to the Manuel lease for the Dominguez Estate Company, did you also go through the same process there with respect to

(Testimony of John H. Wents, Jr.)

determining present worth? A. I did.

Q. What was your figure for present worth?

A. \$53,582.00.

Q. Was that by using a 10 per cent discount factor? A. It was.

Q. Will you explain to the court just what that 10 per [124] cent discount factor is. in a general way?

A. A great many years ago a man by the name of——

The Court: I don't believe I care to have him explain it in any detail. I think I know a little about it.

Mr. Mackay: I will withdraw the question.

The Witness: I could give you the factors I used.

By Mr. Mackay:

Q. Never mind. I made a mistake. I think you have stated your present worth figure of \$53,582.00?

A. I did.

Q. What, in your opinion, was the fair market value of the royalty interest of the Dominguez Estate Company in the Manuel lease on June 5, 1941?

A. The fair market value of the royalty interest of the Dominguez Estate Company in the Manuel lease, as of June 5, 1941, was \$30,363.00.

Q. I think the next one is the Carpenter well.

A. Yes.

Q. What did you determine the present worth of that?

(Testimony of John H. Wents, Jr.)

A. The present worth of the Dominguez Estate Company interest in the Carpenter well as of June 5, 1941, was \$4,696.00.

Q. What was your opinion of the fair market value on that date?

A. The fair market value on that date was \$2,656.00. [125]

Q. Now, let's refer to the Selbar lease. Did you also work out your formula for determining present worth?

A. I followed the same procedure.

Q. What was the present worth figure?

A. The present worth of the Dominguez Estate Company interest in the Selbar lease as of June 5, 1941, was \$5,907.00.

Q. What, in your opinion, was the fair market value on that date?

A. The fair market value was \$3,383.00 as of June 5, 1941.

Mr. Melville: I didn't get the figure.

The Witness: \$3,383.00.

By Mr. Mackay:

Q. I call you attention to the United Supply well.

The Court: I wonder if we couldn't shorten it by taking all of the balance on that exhibit and ask him the question and let him give us the figures. Won't that shorten it?

Mr. Mackay: I think I can make it faster. I would like to have it, if I could, individually.

The Court: Very well.

(Testimony of John H. Wents, Jr.)

Mr. Mackay: I will speed this up.

The Court: I am not trying to hurry you.

Mr. Mackay: I understand, but it could be done.

The Court: Very well.

By Mr. Mackay:

Q. On the United Supply well, what was your present worth as of June 5, 1941?

A. \$2,896.00.

Q. What, in your opinion, was the fair market value?

A. The fair market value of the Dominguez Estate interest as of the same date was \$1,641.00.

Q. Will you just go ahead and give those figures, the present worth and the fair market value of the Standard-Getty lease, please?

A. The present worth, \$4,443.00. The appraised worth \$2,518.00.

Q. What do you say in respect to the Royal Petroleum lease?

A. The present worth, \$80,236.00. The appraised worth or fair market value, \$45,467.00.

Q. How about the C. C. M. O.?

A. The present worth in C. C. M. O. \$3,565.00. Fair market value, \$2,020.00.

Q. Holly Development venture?

A. Holly Development, the present worth \$25,-629.00. The fair market value \$14,523.00.

Q. The Hildon-Caminol lease?

A. The present worth of the Dominguez Estate Company [127] interest is \$16,814.00. The appraised

(Testimony of John H. Wents, Jr.)

worth of the same interest, \$9,528.00. That is the fair market value.

Q. The Wood-Callahan lease?

A. The present worth \$86,626.00. The appraised worth or fair market value \$49,088.00.

Q. What about the Pettyjohn-Jergins-Lebow-McNee lease?

A. The Pettyjohn-Jergins-Lebow-McNee lease, the present worth \$117,346.00. The fair market value \$66,496.00.

Q. That is all of the Dominguez Estate Company; isn't it?

A. Yes, that covers the property.

Q. What is the total appraised value today for all of these? Have you added those up?

A. Yes.

Q. Can you give that, please?

A. The total fair market value of the interest of the Dominguez Estate Company as of the basic date was \$2,701,361.00.

Q. Now, with respect to the Carson Estate, I call your attention to Carpenter well one-third interest. Will you give the present worth and fair market value on that?

A. The interest of the Carson Estate Company in the Carpenter well has a present worth of \$1,638.00, and a fair market value of \$928.00.

Q. What about the Hilldon-Caminol lease of Carson Estate? [128]

A. The Carson Estate interest in the Hilldon-

(Testimony of John H. Wents, Jr.)

Caminol lease has a present worth of \$17,042.00 and a fair market value of \$9,657.00.

Q. What about the Union-Carson lease of the Carson Estate Company?

A. The Union-Carson lease, which is owned completely by the Carson Estate Company, has a present worth of \$287,883.00, and a fair market value of \$163,135.00.

Q. Standard-Carson lease?

A. The Standard-Carson lease has a present worth of \$782.00 and a fair market value of \$443.00.

Q. What is your total for the Carson Estate Company fair market value?

A. It is \$174,163.00.

Mr. Mackay: If your Honor please, I think that I would like to recess, please, for a short time.

The Court: Very well.

Mr. Mackay: I think the reporter needs a rest.

The Court: I think she does, too.

(Short recess taken.)

By Mr. Mackay:

Q. Mr. Wents, have you the average daily production in 1938 and 1939, 1940 and up to the first five months of 1941?

A. In royalty barrels do you mean? [129]

Q. Yes. A. Yes, I have.

Q. Of the total properties of the Dominguez Estate Company? A. Yes, I have.

Q. What are they?

A. The daily royalty barrels for the Dominguez

(Testimony of John H. Wents, Jr.)

Estate Company for the years 1938, 1939, 1940 and the five months of 1941 are as follows:—

The Court: Now, are these figures in the exhibit we have?

Mr. Mackay: No, they are not.

The Court: It is rather difficult to read them into the record accurately and get them accurate, and we have to make up a table. Wherever it is convenient I would like to have, instead of the witness reading them into the record, his schedule introduced as an exhibit.

I am not telling you to do that in every instance.

Mr. Mackay: We will do that. We will submit one tomorrow.

The Witness: If I can prepare one from the sheets here, why, yes.

Mr. Mackay: Can you prepare one tonight and bring it in the morning?

The Court: It is much easier to work on and we [130] are more apt to be accurate.

Mr. Mackay: Mr. Wents, can you work that up tonight and have it here in the morning for us?

The Witness: Yes.

Mr. Mackay: I think that is all.

Mr. Melville: May I ask your Honor what time the court may adjourn for the evening?

The Court: Off the record.

(Discussion off the record.)

The Court: On the record.

You may proceed.

(Testimony of John H. Wents, Jr.)

Cross Examination

By Mr. Melville:

Q. Mr. Wents, do you have with you the price of oil per barrel which you used in converting the barrels of oil into estimated future royalty income for each lease?

A. Yes, I can read those off.

Q. Could you prepare a chart, in line with what his Honor has indicated he would like to have—off the record.

The Court: Off the record.

(Discussion off the record.)

The Court: On the record.

By Mr. Melville:

Q. In your direct examination, Mr. Wents, you referred to many, many royalty transactions which formed the basis of [131] your arriving at the figure of 43-1/3 per cent? A. Yes.

Q. Do you have the details as to those many, many royalty transactions?

A. I have in my files, I believe, considerable records.

Q. Would you bring them to court tomorrow, please?

A. If I can't get them tomorrow I will have them here the next day. It depends on how much I can go through the files. I will try my best to have them ready for you.

Q. Do you know offhand how many of those transactions you used in arriving at the figure of

(Testimony of John H. Wents, Jr.)

43-1/3 per cent? A. No, I don't offhand.

Q. Well, those are the ones that we would be interested in; if you would bring those please, it would be appreciated.

The Court: Very well, we will suspend at this time until 10:00 o'clock tomorrow morning.

(Whereupon, at 4:50 o'clock p.m., a recess was taken until 10:00 o'clock a.m., Tuesday, October 9, 1945.) [132]

[Title of Tax Court and Causes.]

PROCEEDINGS

October 9, 1945, 10:15 a.m.

The Clerk: Docket No. 2257, Victoria L. Cotton.
Whereupon,

JOHN H. WENTS, JR.

resumed his testimony as follows:

Direct Examination (resumed)

By Mr. Mackay:

Q. Mr. Wents, you were requested last night to prepare——

Mr. Melville: Are you going to resume direct?

Mr. Mackay: Yes. I had him prepare a statement of the daily production.

Mr. Melville: I just want to keep the record straight, because the cross examination had started.

Mr. Mackay: Had you started?

Mr. Melville: Yes.

(Testimony of John H. Wents, Jr.)

The Court: Do you wish to examine him further upon——

Mr. Melville: I have no objection. I want to make the record clear on that point.

Mr. Mackay: I think it would be a little better if I clear this point up, if it is agreeable with you.

Mr. Melville: No objection.

The Court: Very well.

By Mr. Mackay:

Q. You were requested yesterday, Mr. Wents, to prepare a table of production from each lease showing the average [137] daily production for the years 1938, 1939, 1940, and the five months of 1941.

A. Yes.

Q. Have you done so? A. Yes.

Q. Is this it here (indicating)?

A. Yes. I had better put them in order. I have done it for both the Carson Estate properties and the Dominguez Estate properties, as requested. There are five properties. That is the Dominguez Estate (indicating).

Mr. Mackay: Your Honor please, I should like to offer this in evidence.

The Court: Is there objection to the receipt of this document?

Mr. Melville: No objection.

The Court: It may be received in evidence as Petitioner's Exhibit No. 23.

(The document referred to was marked and received in evidence as Petitioner's Exhibit No. 23.)

(Testimony of John H. Wents, Jr.)

By Mr. Mackay:

Q. Have you a similar one for Carson?

A. Yes, I have, but in typing this it has been noted the daily average should be down here (indicating). The double lined numerals are the daily average royalty barrels.

Q. You mean the last figure on this one should be the [138] daily average (indicating)?

A. Yes. It so happens that the number of days is the multiple I divided the yearly production by.

Q. You mean the daily average should be below the days? A. That is correct.

Mr. Mackay: If your Honor please, I should like to offer this in evidence.

The Court: Very well. This document entitled "Royalty Barrels By Year, Carson Estate Company" may be marked and received in evidence as Petitioner's Exhibit No. 24.

(The document referred to was marked and received in evidence as Petitioner's Exhibit No. 24.)

By Mr. Mackay:

Q. Now, Mr. Wents, you gave your opinion as to the fair market value of the various oil properties here yesterday. Did you check that opinion with other indices you are familiar with?

A. Yes, I did.

Q. Will you please explain to the Court about that?

A. There are a number of ways of checking an estimate of fair market value against the yard-

(Testimony of John H. Wents, Jr.)

sticks which are used by the man on the street, by some oil operators. Among those yardsticks are the measurements of the value of oil in the ground, royalty barrels of oil in the ground. Another yardstick is the price paid per daily barrel. A third one is the [139] pay-out, monthly pay-out.

In the use of these yardsticks there it is common to use the production for a period of time, say, one month to six months prior to the valuation day.

Now, in my checking I found that with respect to the Reyes lease, which is the major unit of value of the oil in the ground, that is, 6,333,333 barrels of royalty oil which I appraised as having a fair market value of \$2,364,329.00, was equivalent of 37-1/3 cents per barrel in the ground.

Then based upon the average of the five months of 1941, previous to our valuation date, the royalty barrels per day average we divided into my figure of fair market value and it gives a worth of \$1,805.00 for daily royalty barrel.

With respect to pay-out, the average royalty barrel for the five months previous to June 5, 1941, would have to be produced continuously for 49 months in order to pay out, in accordance with my appraised worth figure.

Now, with respect to the totals, approximately the same relation shows. Now, based upon a total for both the Dominguez Estate Company and Carson Estate Company, the oil in the ground is figured at 34 1/4 cents a barrel. The daily royalty barrel rate is \$1,894.00 per daily royalty barrel. I believe

(Testimony of John H. Wents, Jr.)

those figures are fair figures in the light of what is common in royalty trading.

Mr. Mackay: You may take the witness. [140]

Cross Examination

By Mr. Melville:

Q. Mr. Wents, yesterday you were asked to prepare a chart showing the price per barrel of oil you used in arriving at your estimate. Do you have that prepared?

A. Yes, I have. Mr. Melville, these were the prices I not only used, but the prices which were agreed upon in the stipulation.

Q. That is my understanding. A. Yes.

Q. This is for Dominguez; this is for Carson?

A. Yes, these are the names of the leases and the figure to the right is the price per barrel.

Mr. Melville: Your Honor, in an attempt to dispose of as many of the facts in this case by stipulation as possible, extensive conferences were held between both parties, and we tried to agree upon the fair market value of these oil royalties. Failing in that, we went back to the factors which must be considered in arriving at the fair market value of the oil royalties, to see if we could not agree upon those. Those factors are first, the number of barrels in the ground; second, the rate of exhaustion, how fast is it anticipated it might come out; third, the price which it is reasonable to assume will be received for the barrel of oil after it comes out of the ground at some future date. [141]

(Testimony of John H. Wents, Jr.)

We did agree on all those factors and reduced them to net royalty income for the years from 1941 through 1965.

Now, subsequent to preparing that exhibit, which is in evidence, other exhibits have been prepared to go back and show the factors which made up that exhibit, namely, the oil in the ground; and two, the rate of exhaustion. I am simply completing the picture now by offering in evidence a page which shows the price per barrel which was used by both parties in arriving at the factors which have gone into the exhibit which shows probable future royalty income.

I offer at this time as Respondent's Exhibit AA, I believe, the report prepared by Mr. Wents setting forth the agreed price per barrel which was used in connection with the other exhibits which are in evidence.

The Court: Is there objection to the document?

Mr. Mackay: No. If your Honor please, I may state we have stipulated that and it is just a question of working out the mathematics. I certainly have no objection to that.

The Court: It will be received as Respondent's Exhibit AA.

(The document referred to was marked and received in evidence as Respondent's Exhibit AA.)

[Respondent's Exhibit AA set out in full in Book of Exhibits.]

(Testimony of John H. Wents, Jr.)

By Mr. Melville:

Q. Mr. Wents, you testified yesterday that you had recently appeared as a witness before the United States District [142] Court in a valuation proceeding. Is that correct?

A. I testified I had appeared and one of the cases was recent.

Q. Recently.

A. I did not say that yesterday, but one of the cases had been recent.

Q. I understood you to say you had been recently a witness for the government?

A. That is true, yes.

Q. Was that a case before the United States District Court? A. Yes.

Q. Did you testify in that case as to a value of around \$10,000.00?

A. Yes, I believe so.

Q. Did the jury find the value of around \$20,000.00, or twice your figure?

A. The jury found a value which was composed of two units, which was around \$20,000.00, I believe.

Q. I believe you also said yesterday that you had had experience in valuing oil properties in the light of selling and in the light of purchasing?

A. Yes.

Q. Did you value them differently?

A. No. [143]

Q. If you were valuing oil properties for a prospective purchaser, you would value it in the same way that you would value it if you were

(Testimony of John H. Wents, Jr.)

valuing it for a prospective seller?

A. I would furnish the prospective purchaser and/or the prospective seller with my idea of the fair market value of the royalty upon which I had been requested to make an appraisal.

Q. Would you use the method you have used in this case? A. Yes.

Q. Then you would arrive at the same value whether you were furnishing it to the prospective buyer or to the prospective seller?

A. Yes, I would.

Q. You testified that you had valued oil royalties for Diversified Royalties, Ltd?

A. I did.

Q. Do you have any opinion as to—has the Diversified Royalties gone into bankruptcy?

A. The Diversified Royalties did go into bankruptcy.

Q. Was that due, in your opinion, to the fact you valued the oil royalties for the purchaser, by Diversified Royalties, in the same formula you valued it for the sale of Diversified Royalties?

A. I did not value for the sale of Diversified Royalties.

Q. Your testimony is you made no valuation for Diversified Royalties with respect to sales? [144]

A. I made certain exhibits for Diversified Royalties, not appraisals. I prepared certain exhibits. The Diversified Royalties appraisals were prepared by outside engineers; that is, with respect to the selling.

(Testimony of John H. Wents, Jr.)

Q. With respect to the buying?

A. With respect to the buying, I prepared the appraisals with respect to the buying; that is, in a great number of instances. Sometimes my work was checked by the employment of another appraiser.

Q. What connection did your father have with Diversified Royalties?

A. My father was vice-president of Diversified Royalties, I believe.

Q. What was your connection?

A. I was an employee of Diversified Royalties for a time. I held a nominal title of vice-president. I never had any voting capacity.

Q. Did you sell royalties to Diversified Royalties? A. No.

Q. Did your father?

A. Not that I know of; he may have. I was with Diversified Royalties a much shorter time than my father was with them.

Q. Did the Securities and Exchange Commission ever conduct an investigation into Diversified Royalties? [145]

A. The Securities and Exchange Commission?

Q. That is right.

A. Not that I know of.

Q. Did the Corporation Commission of California ever conduct an investigation into the operation of the Diversified Royalties?

A. Yes, it did.

Q. Do you have with you or available any copies

(Testimony of John H. Wents, Jr.)

of appraisals that you made and submitted to Diversified Royalties? A. No, I do not.

Q. You couldn't obtain them, even by tomorrow?

A. I obtained from my files certain of the information requested of me yesterday; that I had compiled. However, with respect to the appraisals made for Diversified Royalties, I am not sure whether I have any of that material in my files or not, excepting in very sketchy form.

Q. Yesterday you read into the record the figures from 1938 to 1940, inclusive, and for the five months of 1941 as to the oil royalties of Dominguez Estate Company, and it showed it declined from 845,870 barrels in 1938, and so forth. Do you have those figures?

A. Those are the figures I had copied, and were furnished to you.

Q. Do you have them in front of you?

A. Yes, I have them. [146]

Mr. Mackay: It is in this exhibit (indicating).

Mr. Melville: It was just as much in evidence yesterday, too.

Mr. Mackay: I am sorry. I was just trying to be helpful.

The Court: Off the record.

(Discussion off the record.)

The Court: On the record.

By Mr. Melville:

Q. Now, Mr. Wents, in going back to 1938 and reading forward to 1940 and the first five months of 1941, it showed a declining rate; didn't it?

(Testimony of John H. Wents, Jr.)

A. These figures disclosed a declining rate, yes.

Q. If you go back to 1927, what does it show?

A. My figures do not go back to 1927. They go back to 1930.

Q. They go back to 1930. What was the figure, corresponding figure?

A. The total royalty barrels produced from Dominguez Estate leases for the year 1930 was 383,756.

Q. Do those figures, from the years 1930 to 1938, show a gradual increase in production?

A. They show a gradual increase to the year of 1938, yes.

Q. That is what I wanted to bring out. Now, Mr. Wents, does the federal government by any rulings or regulations [147] curtail the production of oil?

A. The federal government does not curtail the production of oil in California.

Q. Does the State of California curtail the production of oil or have they curtailed the production of oil in the State of California?

A. The State of California does not curtail the production of oil in California.

Q. Does anybody curtail the production of oil in California, Mr. Wents?

A. Yes, a conservation committee curtails the production of oil in California.

Q. All right. Does that curtailment of production of oil have any direct bearing on the facts that

(Testimony of John H. Wents, Jr.)

there has been a decrease from 1938 to 1941 in the amount of oil produced?

A. It has some bearing, yes.

Q. Thank you. You went into considerable detail yesterday in valuing each of the leases of the Dominguez Estate Company and of the Carson Estate Company? A. I did.

Q. Do I understand your testimony to be in each case you used, first, a 10 per cent discount factor, and second, a $43\frac{1}{3}$ discount factor?

A. I did.

Q. Are you familiar with a term used in the oil industry [148] as a "blue chip" property or a "blue chip" lease? A. No, I am not.

Q. Do you consider all of these leases to be of equal value? A. No, I do not.

Q. Which lease do you consider to be best?

A. The Reyes lease.

Q. And of the total amount of oil in reserve in all leases, does the Reyes lease represent something, about 90 per cent of the total?

A. The relationship between $6\frac{1}{3}$ million and $8\frac{4}{10}$ million would express it.

Q. Do you have a slide rule?

A. No, I have not, with me.

Q. Which would you say was the least desirable lease?

A. I would say probably, if any of the leases were in question regarding desirability, the unexplored areas of the Torrance lands would have the most.

(Testimony of John H. Wents, Jr.)

Q. But you did value all of the leases by using exactly the same discount factors for the Reyes lease, which comprises substantially all of the oil reserves right straight through, including all of the leases which are of less desirability?

A. Yes. However, in the use of that factor those things are weighed out and the answer comes out much differently in the end. For example, the oil in the ground in the Reyes lease [149] is valued at approximately 40 cents a barrel. The oil in the ground on the Torrance leases is only valued at 14 cents a barrel.

Q. And you feel that that difference justifies using the same formula for each lease?

A. Why, the answer, the justification of the use of the formula—because different answers are had—the formula is just a means of arriving at the value. The values will not be one—you couldn't put a blue chip against a brown chip, if you want to use those terms, or a sound royalty against a speculative royalty by using the approach I used.

Q. And is this same method of valuing by discounting 10 per cent and then $43\frac{1}{3}$ per cent, is that the method you used in valuing royalties for Diversified Royalties? A. Yes, it is.

Q. Under the leases involved, did the lessors have the right to receive the oil in kind at their option?

A. Yes, depending upon the exercise within certain periods of time.

(Testimony of John H. Wents, Jr.)

Q. It was within their option to take the oil in kind if they wanted it?

A. That is correct.

Q. And prior to 1940 the fee owner had, from time to time, taken royalty in kind; had it not?

A. From certain properties. Not from oil properties at all times. [140]

Q. When they did so, they sold it to purchasers for bonus prices of more than 20 cents per barrel above the posted price of oil which the lessee was required to pay; is that correct?

A. I believe the Socal contract was based on about that.

The Court: What contract?

The Witness: Socal, the name of a refining company.

The Court: Some of these terms are unfamiliar to the reporter.

The Witness: S-o-c-a-l.

By Mr. Melville:

Q. Was about at that figure?

A. I am not sure.

Q. Wouldn't you say that each time the lessors chose or elected to take oil royalty in kind it was for a price advantage? A. No, I would not.

Q. What other purpose would there be to take oil in kind, rather than the royalties at the posted price?

A. May I explain that the Dominguez Estate Company has taken the oil in kind from the Reyes lease for many years. The Shell Oil Company is

(Testimony of John H. Wents, Jr.)

the operator of the property by letter agreement between the Dominguez Estate Company and the Union [151] Oil Company. The Union Oil Company takes the Reyes oil, the royalty share of the Reyes oil, and pays it at the same price as posted by the Union Oil Company and adopted by the Shell Company in the field.

Q. That is as to the Reyes lease?

A. The Reyes lease.

Q. Wasn't the oil from the Reyes lease ever sold at a bonus above the posted price?

A. That question was answered. Yes.

Q. Now, the oil prices that you used in your valuations do not include any possible future bonuses in excess of the oil, posted oil prices; do they?

A. No, they do not.

Q. You said yesterday that you discounted probable future royalties to present worth by using the Hoskhold's Formula, and you started to tell the Court about that formula but were interrupted, I believe, after saying, "A long time ago a man named——"

A. That is right.

Q. Your introductory remarks started like a fairy tale. I would like to hear the rest of it.

A. The Hoskhold's Formula is a formula upon which the present value of a dollar returnable—is payable some years hence, one year or a fraction or a year or many years hence, at a certain rate of discount. It is calculated, in other [152] words, a dollar which is coming to you six months hence at the rate of 10 per cent is equivalent to 95 and

(Testimony of John H. Wents, Jr.)

a fraction cents in your pocket today. It goes on down the list. A dollar which is due two years hence is worth 86 and a fraction cents.

Now, the formula or the table used is just an adoption of the Hoskhold's Formula, based upon the factor and recognizing the fact that royalty incomes are received monthly. And it compensates for that because the dollar does not come to you at the end of a specific period of time, but comes to you during a period of time.

Q. Does the Hoskhold's Formula use one discount factor or two?

A. The Hoskhold's Formula on the 10 per cent table is one discount factor, as I used. Maybe in certain cases the Hoskhold's Formula involves two discounts.

Q. I know. You said yesterday that you didn't have a degree in engineering. Don't you know that a formula is something definite rather than something variable?

A. The formula that I used—I can recite the formula I use.

Q. We are talking about the Hoskhold's Formula. Does it contain more than one discount factor?

A. I am not sure. I did not derive the tables. I use the tables, but I did not derive the tables.

Q. Do you have a copy of Hoskhold's book entitled "Engineers' Valuing Assistant"?

A. No, I do not.

Q. Have you ever read it?

(Testimony of John H. Wents, Jr.)

A. I have read parts of it.

Q. Why didn't you read it all?

A. Because I wasn't interested in it all.

Q. Are you following the Hoskhold's Formula?

A. No, I am following an adaptation of the Hoskhold's Formula, derived by Dr. Burt of the Shell Company.

Q. Where did you get your information regarding the Hoskhold's Formula?

A. I suppose I was first introduced to it in Brown's "Valuation of Oil Lands."

Q. Do you know who Hoskhold was?

A. He was an Englishman, I believe.

Q. What period of time did he live?

A. In the early 1800's, I believe.

Q. Does the Hoskhold Formula contain a sinking fund factor?

A. Certain of the Hoskhold Formulas contain sinking fund factors.

Q. You mean there is more than one Hoskhold Formula?

A. There are different uses of the Hoskhold Formula, according to the Hoskhold textbook, and according to the uses— [154] I mean the reprints of portions of the Hoskhold's text you have a series of inter-rates, inter-tables worked out whereby the present values can be read, directly read, based upon—or the present value factor can be read direct. Certain of those tables embody sinking funds; certain of them do not.

Q. Is it your testimony now there is more than

(Testimony of John H. Wents, Jr.)

one Hoskhold's Formula, or only one and various applications of it?

A. There is probably one and various applications; I am not sure.

Q. Don't you know? A. No, I do not.

Q. You do not know whether there is more than one Hoskhold's Formula?

A. I am of the opinion there is more than one Hoskhold's Formula, each for a different purpose. It may be that my opinion is wrong and there are only variations.

Q. That being the case, when you decided to use the Hoskhold's Formula, how did you select the one you wanted to use?

A. I used the 10 per cent factor consistently in all of my appraisals, for the simple reason that the answer that I get from that is only a part of my ultimate answer. It is not the answer to the problem; it is a part.

My professors in college dwelt upon that a lot. I probably followed their lead in the using of the factors. They [155] might have perhaps differed in the choice of 6 per cent, 7 per cent, 8 per cent, 9 per cent, or 10 per cent. Or they might have referred to sinking funds in them. I chose, for my purposes, the 10 per cent table and I use that exclusively because then I can reduce it to my figure of fair market value. If there is any other table used by a different appraiser for my purposes, I translate it to 10 per cent.

(Testimony of John H. Wents, Jr.)

Q. Is it your opinion that 10 per cent is a reasonable rate of interest?

A. I do not use the 10 per cent table to reflect a rate of interest or money worth.

Q. Does the Hoskhold's Formula provide for retirement of capital prior to the termination of the investment period?

Mr. Mackay: Well, if your Honor please, I don't—

The Witness: That is a sinking fund.

Mr. Mackay: It seems to me his cross-examination is improper. We didn't go into the Hoskhold's Formula yesterday.

The Court: Well, I stopped him from going into it. I thought I knew something about what he meant by the Hoskhold's Formula; I am not sure I do. We will let him proceed with the cross-examination.

Mr. Melville: I am proceeding on the theory the witness doesn't, either.

Mr. Mackay: We will keep on; you will find out. [156]

By Mr. Melville:

Q. Did you answer the question?

The Witness: Will you repeat the question?

(The record was read.)

The Witness: There are certain tables provided in Hoskhold's book which provide for retirement of principal, as well as interest.

By Mr. Melville:

Q. Isn't it a fact that the Hoskhold's Formula

(Testimony of John H. Wents, Jr.)

has two rates of interest, one a speculative rate on the investment, and another, a safe rate on the sinking fund? A. Perhaps then I have——

Q. You can answer that yes or no.

A. I am not sure.

Q. Does the Hoskhold's Formula apply only to the valuation of equal annual income throughout the investment period?

A. I think in certain instances the tables are worked out on the basis of equal annual income; but other instances they are not.

Q. You mean the formula would be the same formula and would be applicable to a situation——

A. I said there were probably more than one formulae.

Q. Let's talk about the one you know about. Does that formula apply as well to a situation where you have equal annual income as it does to one where you have diminishing annual income?

A. The one I use applies the same.

Q. Does the Hoskhold's Formula apply equally to the situation where you have constant annual income, as well as to the situation where you have diminishing annual income?

A. The Hoskhold's, I believe, applies to constant.

Q. And does not apply to a situation where you have diminishing annual income?

A. I am not sure, but I would say no.

Q. Could you explain just how you modify the Hoskhold's Formula in order to apply it in this

(Testimony of John H. Wents, Jr.)

case for valuing equal annual income—pardon me—to apply it in this case for valuing unequal annual income?

A. In this case the table or the factors that are used takes into consideration that the income of all royalties is payable, or the income is payable monthly, and that the income had during the first period of the year will be slightly greater than that had during the second period of the year.

Q. Then it is your testimony, as I understand it, that you did not use the Hoskhold's Formula?

A. I used a formula derived by Dr. Burt of the Shell Company, a formula which I was taught was more adaptable for the purposes of oil valuation than the true Hoskhold's Formula.

Q. What is his name? A. Dr. Burt. [158]

Q. Take the Reyes lease, Mr. Wents, what was its 1941 probable oil income after June 5, 1941?

A. Based upon the estimate which was made a part of the stipulation?

Q. That is right.

A. The seven months remaining in 1941?

Q. That is right. A. \$368,645.00.

Q. What was the discount factor which you used in discounting that to present worth?

A. .9535.

Q. Then you took off another 43 1/3 per cent to get what you called fair market value?

A. From the sum of the present worth accruing for each of the years—that is, accruing from the income for each of the years from 1941.

(Testimony of John H. Wents, Jr.)

Q. I don't believe that is responsive to the question, Mr. Wents?

A. In the ultimate I took off 43 1/3 per cent at the end. I didn't do it by years.

Q. If you didn't take it off in the first year, I take it, you didn't take it off until the very end?

A. I took it off of the sum of the present worth.

Q. At the very end, 1965?

A. When I assumed my present worth, which is past 1965, [159] the answer I got there at that point, which was \$4,172,321.00, was discounted by 43 1/3 per cent; the answer being my opinion of the fair market value of the property, or \$2,364,-329.00.

Q. As I understand your testimony, then, you didn't apply that discount factor of 43 1/3 per cent to any particular year, but to the grand total?

A. It is applied probably indirectly to each particular year. I applied it to the grand total.

Q. But to no particular year?

A. No particular year.

Q. Does the Burt Formula, which you said you used, provide for applying the formula for each particular year or to anticipate for 20 years in the future and apply it at the end?

A. No, the formula for each particular year.

Q. So that you didn't follow the Burt Formula either? A. I did.

Q. But you didn't apply your factors to each particular year; did you? A. Yes, I did.

Q. You say you did, now?

(Testimony of John H. Wents, Jr.)

A. Yes. I didn't apply my 43 1/3 per cent to each individual year; that was your other question. The Burt factors were applied to each individual year.

Q. That clears that up. Mr. Wents, if you didn't take that 43 1/3 per cent out of the first year's income, what year [160] did you take it out of?

A. I didn't take it out of any specific year. I took it out of the total.

Q. Then would that be taking it out pro rata for each year?

A. It would have the effect of taking it out pro rata for each year.

Q. Now, coming back to the first year, applying that then back to the first year, how many cents on the dollar was one barrel of oil worth, according to your appraised value?

A. To the first year?

Q. Yes. A. I would have to figure it out.

Q. Would you do so now, hurriedly? Would you be surprised if I told you it was 54 cents on the dollar?

A. It might be well to explain that the discount there of 43 1/3 per cent anticipates the life of the property, which is extremely longer than a year. I would not deny the first year's income was worth more than the second year's. I would also say the second year's income would be worth more than the third. However, over a period of 25 years, with the various things that might be happening in that

(Testimony of John H. Wents, Jr.)

period of time, then the composite of $43\frac{1}{3}$ is applicable.

Q. Now, $43\frac{1}{3}$ then is derived, recognizing it is to apply over a period of years? [161]

A. Over a period of years.

Q. How long a period of years?

A. I have used it indiscriminately between 20 and 30 years. If my income is coming to me faster than that, I change it.

Q. Take your total valuation of \$2,701,000.00 for all the probably future royalties in all the developed royalties reserves of Dominguez Company——

A. \$2,701,361.00.

Q. ——what percentage rate of interest would an investor receive over and above income taxes on a return of his investment if he could buy those royalties at the value you have placed on them?

A. Will you repeat that question?

Mr. Melville: Yes.

(The question was read.)

The Witness: I do not know.

By Mr. Melville:

Q. If I should tell you that the rate of return would be 18 per cent compound interest for more than 25 years, would you be surprised?

A. I would be muchly surprised.

Q. If we can establish that that is the correct percentage, would you be willing to change your opinion as to the valuation? [162] A. No.

Q. Then what leads you to believe that such a

(Testimony of John H. Wents, Jr.)

rate of interest is justified for such a high-class oil royalty as we are dealing with here?

A. There is an assumption made there that is not logical. Providing that a guarantee might be had that the yearly rates of production and the incomes, as we have figured them here, would be had without failure, then my answer is wrong. But providing there might be, there is any number of things that might affect the production, the future production.

Q. Are you getting away from the stipulation?

A. Getting away from the stipulation?

Q. Yes.

A. We did not stipulate to value in the stipulation.

Q. We have stipulated the probable future royalty income.

A. That is an estimate I used as a guide in arriving at my figure of value.

Q. Using the stipulated figures as to probable future royalty income, if it were established to your satisfaction that that works out, working it backwards, to a percentage of 18 per cent compound interest, would you consider that to be a fair rate for oil royalties such as the Dominguez Oil Field?

A. As you last state it, I think your answer may be right. [163]

The Court: What do you mean by that? I don't understand your answer.

The Witness: He changed the wording of his statement there. And assuming that it could be a

(Testimony of John H. Wents, Jr.)

guarantee these things would happen, then his answer may be correct?

The Court: His answer?

The Witness: Or his statement. He made a statement. His statement may be correct.

The Court: Very well. You may proceed.

By Mr. Melville:

Q. What value did you attribute to the royalties from the Reyes lease of 1965?

A. The present worth after 1965 of the income is \$19,848.00.

Q. Did you apply your other factor of 43 1/3 per cent to that?

A. Not specifically to that figure.

Q. Why not?

A. I applied it to the aggregate of all the figures, and that figures a part of the total.

Q. Exhibit 11-K(2) has a subtotal of \$7,459,745.00, and a total of \$7,790,000.00. Which of those did you apply your factors to?

Mr. Mackay: What factors are you talking about?

Mr. Melville: 10 per cent and 43 1/3 per cent.

Mr. Mackay: If your Honor please, I don't think we are trying to put a value in 1965 upon anything. We are trying to confine our values to June 5, 1941. The witness has not testified yet as to the fair market value in 1965 of any particular properties. It is not in issue, it is not proper cross-examination.

It is true, so far as our estimated oil reserves and

(Testimony of John H. Wents, Jr.)

the probable rate they should come out of the ground, have been stipulated. Certainly, we haven't gone into the fair market value in 1965, and there is no testimony along that line.

The Court: If I understand the witness correctly, he applies his 10 per cent factor on each of the years.

The Witness: That is correct.

The Court: And then after he did that, he added all those up and applied the 43-1/3 per cent factor.

The Witness: Yes, I think that is right, your Honor. That is correct.

Mr. Mackay: And in doing that, to arrive at what he called present worth. Now, we are getting down here to determining fair market value, and that applies only to fair market value on June 5, 1941, not 25 years from now.

Mr. Melville: My questioning was directed to ascertaining what, in the opinion of this witness, the 1941 value is or was of the future royalty income stipulated as [165] probable on Exhibit 11-K(2); the 1941 value of the right to receive subsequent to 1965 the royalty income stipulated.

By Mr. Melville:

Q. Is the question clear?

The Court: Do you understand the question, Mr. Wents?

The Witness: Yes, I do.

The Court: You may answer it, please.

The Witness: The answer would be 56 2/3 per cent of \$19,848.00.

(Testimony of John H. Wents, Jr.)

The Court: Where do you get the \$19,848.00?

The Witness: There is 1,611,000 barrels of oil, which will be produced, in accordance with the stipulation, after the year of 1965. The royalty share on that number of barrels of oil is \$268,500.00. The price agreed upon for the oil throughout that period was \$1.23, which gives \$330,255.00 of expected income to be had after 1965.

By Mr. Melville:

Q. What was that figure again?

A. \$330,255.00. The discount factor I applied to that, to compensate for its deferment, was .0601, which is about the discount for approximately the 30th year.

The present worth of that income, that is, what it would be worth in accordance with those discount tables is \$19,848.00. And as far as appraised worth is concerned, following [166] my system, I might analyze that figure and say it is worth probably 56 2/3 per cent of it.

Q. Now, Mr. Wents, would you advise your employers to sell, or would you have advised your employers in 1941 to sell their right to receive that \$330,255.00 following 1965 for the insignificant sum of \$19,848.00?

A. I think I can truly say yes to that question.

The Court: His answer was 56 per cent of the \$19,000.00?

The Witness: Yes; taking all the factors into consideration I could say yes.

(Testimony of John H. Wents, Jr.)

Mr. Melville: I didn't get your Honor's comment.

The Court: His figure was 56 per cent of the \$19,000.00.

The Witness: Yes.

By Mr. Melville:

Q. That would make it how much?

A. Roughly about \$9,500.00, something like that; \$10,000.00.

Q. Would you advise your employers today, October, 1945, to sell that right to receive that much money, \$330,255.00 following 1965, on the same basis of appraisal as you have testified to here?

A. Taking the factors into consideration, go into this appraisal and analysis of that which will come after 1965, I [167] would say yes.

Q. Yesterday I asked you, Mr. Wents, to produce a complete list of the royalty sales data upon which you relied for your arriving at the discount factor of 43 1/3 per cent. Do you have that data with you this morning?

A. I couldn't compile a complete list because there were many, many, I told you. However, I have lots of the data available.

The Court: We will suspend at this time for a brief recess.

(A short recess.)

By Mr. Melville:

Q. Mr. Wents, I believe you testified yesterday that one of the factors which you took into consideration in arriving at your opinion of fair market

(Testimony of John H. Wents, Jr.)

value was the assumption that the seller would have a place to put his money which would be more advantageous to him than to leave it tied up in oil royalties; is that correct?

A. You will have to repeat that because I missed, I might have missed part of it. I want to be sure about it.

Q. I want you to be sure. I believe your testimony yesterday was to the effect that one of the factors which you took into consideration, in arriving at the fair market value, that is, the value at which the willing buyer and the willing seller would meet and agree, was that you presumed the seller [168] would have a place to put his money which would be more advantageous to him than to leave it in the oil royalties.

A. To be a willing seller, I believe that that factor would come into existence, yes.

Q. Can you suggest to this Court any place where a prospective seller could put his money, which would be more advantageous than to put nine thousand some dollars down on the line in 1941 for the right to receive, not a life annuity in 1965, but an estimated amount of money totaling \$330,255.00?

A. Well, that is beyond my province as an engineer and geologist. I would say that problem should be referred to an investment man.

Q. Then you don't know of any place that money could be better invested than that; do you?

A. I would say it would be a poor investment, myself; the nine thousand or whatever that figure

(Testimony of John H. Wents, Jr.)

is, to share in the oil which might be produced from that property after 1965, in accordance with our stipulation.

Q. Aren't you getting away from the stipulation?

A. No, I am not getting away from the stipulation.

Q. According to the stipulation and your testimony there will be received in all probability subsequent to 1965 oil royalties in excess of \$300,000.00.

A. Subsequent to 1965, that is true; how much subsequent, I don't know. [169]

Q. Now, Mr. Wents, yesterday I asked you to bring to court not all of the sales data which your files might disclose, but only those which you used in arriving at this formula or discount factor of 43 1/3 per cent. You said yesterday, I believe, that that 43 1/3 per cent was the mean between, or was the average of the various sales which were actually made, which you had analyzed?

A. Yes, that is true.

Q. That is correct? A. Yes.

Q. Do you have in court the sales which you analyzed and which resulted in your arriving at this average of 43 1/3?

A. I have a record of the sales which will disclose that that is the substance. I have a record—

Q. In what form is that record?

A. It happens to be in this form (indicating). I cite the royalty, the lease, the field, the percentage of which this transaction was a part, the price at

(Testimony of John H. Wents, Jr.)

which it was figured per barrel of oil, the discount factors, the per cent worth factors, the present value. I cite who the royalty was bought from, the date of the purchase, the purchase price, and the relationship of the purchase price to the present value as figured in the 10 per cent formula. That is my compilation.

Q. This folder you gave me, Mr. Wents, contains 15 or 16 pages similar to the one which is captioned "Superior Oil [170] Company—Ruhl Lease"?

A. Yes.

Q. That means that there were 15 or 16 sales that you analyzed in arriving at your percentage of 43 1/3?

A. There so happens to be 15 or 16 in that folder, but there probably are many, many more. There are many more.

Q. How many did you analyze in order to arrive at your 43 1/3?

A. I was in the business of appraising royalties for Diversified Royalties for approximately five years. The purchase of royalties by that organization, during that five years, amounted to approximately a million dollars a year. Probably there were ten million dollars or more of royalties submitted to that corporation, and in each case analysis was made of the present worth of that future income. I set forth a price which I figured was the fair market value or the fair price for the royalty interest. Included in that compilation is only a

(Testimony of John H. Wents, Jr.)

few, but there is enough of a swing there that it shows the average, in my estimation.

Q. Well, now, is it your testimony then that if we will take these 15 or 16 sales and do just as you said, average them all up to figure the relationship between the purchase price and the actual sales price, that we would arrive at a figure of 43 1/3?

A. Yes, the arithmetical average is around 43 1/3. But [171] the weighted average would be much lower than that.

Q. When did you arrive at that value figure of 43 1/3 per cent?

A. I arrived at that probably some time in 1936 or so.

Q. You have been using it ever since?

A. I have.

Q. Then if you have used that in—you have testified you have used that in valuing the royalties in this case as of 1941?

A. Yes.

Q. Then you didn't take into consideration any factors which developed or which a willing buyer and a willing seller would have known in 1941, which you didn't know back in 1936?

A. The same conditions with respect to prophecy in the future existed in 1936 as it did in 1941; five years didn't change it any.

Q. Have you checked your appraisal with any sales made subsequent to 1941?

A. I have not been in the business of buying and and selling royalties since 1941.

(Testimony of John H. Wents, Jr.)

Q. Do you know of any sales that were made on or during the year 1941? Do you know the facts regarding such sales?

A. Not as well as I do the facts regarding sales prior to 1941 and approaching 1941.

Q. Do you know of any sale that was made of oil royalties [172] in 1941 by anybody in Southern California, to anybody else?

A. The complete facts?

Q. Do you have knowledge?

A. Yes, I have knowledge of sales.

Q. What sales do you have in mind now?

A. There were royalties sold in the wells which were drilling on the west limb of the Dominguez field in the year of 1941 in drilling wells. I have knowledge that Wilmington royalties were sold in the year of 1941. But specific knowledge with respect to what might be recovered from those royalties or what the price paid for those royalties or whether the buyer knew what he was buying, or the seller knew what he was selling, I don't know.

Q. Is that true with respect to the years 1942, 1943, 1944 and up to date?

A. I hear of royalty sales and royalty purchases, but as far as making an analysis of royalty sales and royalty purchases of those on the outside, I have not.

Q. You have, then, as I understand your testimony, not made any attempt to check your method of appraisal, that you have used in this case, with

(Testimony of John H. Wents, Jr.)

any sales, actual sales which were made subsequent to 1936?

A. Why, yes. That is wrong because subsequent to 1941 would be the time.

Q. Did you testify that you reached this figure of [173] 43 1/3 per cent in 1936, or was it 1926?

A. 1936. I found no reason to make a change in it.

Q. Have you checked it with any actual sale of oil royalties subsequent to 1936? A. Yes.

Q. Tell me about it.

A. You will find them listed on the card there, the dates (indicating).

Q. There aren't any in here subsequent to 1938; are there? A. I don't know.

Q. Will you look and see?

A. (Witness complies): Yes, several.

Q. Show them to me.

A. June 18, 1939; January 23, 1939; March 7, 1939; February 18, 1939; August 29, 1939; January 27, 1939; January 16, 1939; January 26, 1939; February 2, 1939.

Q. Thank you. Now, let's take these you just referred to that were made in 1939. The first one is the royalty of O. D. Oil Company, H. B. No. 1. The field was Huntington Beach. Did you appraise that at any time? A. Yes, I did.

Q. What did you appraise it at?

A. I do not remember.

Mr. Mackay: Let him have the book. Maybe he can tell you. [174]

(Testimony of John H. Wents, Jr.)

The Witness: That particular royalty or this particular group of royalties are appraised here as a group. This particular sheet does not show the individual appraisal of that royalty. However, I believe it may be shown somewhere else. I don't know whether they are shown separately in there or not.

By Mr. Melville:

Q. Mr. Wents, the data with respect to sales you have brought to court this morning, in response to my request yesterday, all relate to rather small sales; do they not?

A. Well, it depends on what you mean by "small". Small is a vague term.

Q. Well, would you say that the oil royalties that we are valuing in this case are large?

A. In the Dominguez Estate case?

Q. Yes. A. Yes, they are large.

Q. That is also a vague term.

A. That is a vague term there. Let's split it. In other words——

Q. In comparison, Mr. Wents, to the oil that we are dealing with in this case, do any of these royalties compare in any way in the size of the amount of oil involved or future royalties income to be received, or on any other basis are they comparable? [175]

A. With respect to the oil which we delivered from certain of these leases or can be expected from certain of these leases, the royalties included in this group in this book, shown in this book, in

(Testimony of John H. Wents, Jr.)

certain instances are larger than the barrels of oil reproduced in the Dominguez Estate leases.

Q. Would you call my attention, please, to the one you think is most comparable to the oil royalties we are trying to value in this case?

A. We have a spread of royalties across the Santa Maria field, where the recoveries from the leases and the ultimate recoveries will be several times the expectancy we have from the Dominguez Estate property.

Q. Show me in the book the one you are talking about.

A. Right here (indicating), the Fernandez lease, the Rosecrans lease, Vincent lease, Willis lease, Rice lease. There are others.

Q. The total barrels that we have here for all of these leases is how much?

Q. The total royalty barrels in this instance of this appraisal is 20,105.

Q. How does that compare with the total royalty barrels we are dealing with in this case?

A. If I were evaluating the same fractional interest in the Dominguez Estate case, as we have here, we would have a lesser figure in the Dominguez Estate case than we do in this [176] case.

Q. How many barrels of oil did we agree upon as the basis of the stipulation of facts in this case?

Mr. Mackay: Do you want the stipulation?

(Testimony of John H. Wents, Jr.)

The Witness: A grand total of 50,000,000, if I understand your question.

By Mr. Melville:

Q. That was comparable, you think, to the 20,105 here?

A. 20,105 does not reflect the same relationship between the fraction appraised in the Dominguez Estate Company and the fraction in that case. In other words, those two fractional interests are not the same. However, if I multiplied that recovery there by, or increased it so it was equivalent to approximately $16 \frac{2}{3}$, we are appraising in the Dominguez Estate case, we would have a larger total there.

Q. But the fact is you are dealing with an actual sale of royalties in this case?

A. An actual sale.

Q. And the sale price was how much?

A. \$3,476.00.

Q. So you are comparing a sale of oil royalties for \$3,476.00 with oil royalties which you yourself appraise in the neighborhood of \$3,000,000.00?

A. Yes, there is that comparison there.

Q. Thank you. Mr. Wents, did you at one time make a [177] summary of oil developments and production on the lands of the Dominguez Estate Company and the Carson Estate Company, along about March 1, 1944?

A. I did. I believe that is the date.

Q. During your testimony in this case have you stated either on direct or cross examination all

(Testimony of John H. Wents, Jr.)

of the factors which you consider in arriving at your opinion as to the fair market value of the oil royalties involved? A. No, I have not.

Q. Did you state, in your book, and you may turn to page 6 if you want to check my quotation—— A. Which book is that?

Q. That is the one——

A. What is the title of it?

Q. "Summary 1942-1943 Oil Development and Production." A. Yes. What is the page?

Q. 6. Did you state in that report that a rise in oil prices "is thought to be inevitable"?

A. I did.

Q. Did you take that into consideration in arriving at the valuation that you have testified to in this case?

A. This report was made in, I think, you stated March or something of 1944. Considering it as of the date of June 5, 1941, I did not. I used the factor which was, or the price which is agreed upon by stipulation. [178]

Q. What made you think in 1944 that a rise in oil prices was inevitable?

Mr. Mackay: I object to that, not proper cross examination.

Mr. Melville: I want to show he certainly had the same reason to think that in 1941.

The Court: Overruled. He may answer.

The Witness: May the question be repeated?

Mr. Melville: Certainly.

(The question was read.)

(Testimony of John H. Wents, Jr.)

The Witness: I thought because of the demand which was had in 1944 and the lag in discoveries that an oil price rise should be had. I thought wrong, though.

By Mr. Melville:

Q. Would you read the rest of the paragraph, Mr. Wents, into the record?

Mr. Mackay: Just a moment. May I see it, first?

Mr. Melville: Yes.

Mr. Mackay: I want to see the book. Thank you.

The Court: Off the record.

(Discussion off the record.)

The Court: On the record.

The Witness: That paragraph as a whole reads as follows:

“A rise in oil prices is thought to be inevitable. [179] To the owners of oil lands a price increase will mean much. It will encourage the extraction of the maximum recoverable oil by paving the way for reconditioning of old wells; it will make possible the application of costly secondary recovery methods; and, it will cause new wells to be drilled at locations now considered marginally profitable.”

Q. One more question, Mr. Wents. If before this trial is over the government produces witnesses who will testify that they were buying oil royalties and were in a position to buy oil royalties of this size in 1941, and if they testify they would have been glad to have bought these at figures between four and five million dollars, would that testimony from

(Testimony of John H. Wents, Jr.)

willing buyers change your opinion?

A. No.

Mr. Melville: No more questions.

Redirect Examination

By Mr. Mackay:

Mr. Wents, you just referred to page 6 and you read a paragraph, I think. May I see that a minute?

A. Yes.

Q. Mr. Wents, you were asked to read by counsel, I think, a paragraph on page 6. Will you please read paragraphs on 6, 7 and 8 and the middle of page 9?

Mr. Melville: Let's put the whole book in, if you want to, Mr. Mackay.

Mr. Mackay: I don't want to put the whole book in.

Mr. Melville: Let's see what he wants to read.

Mr. Mackay: O. K.

Mr. Melville: I object to this, your Honor, on the ground it recites factors which developed between 1941 and 1944 when the book was written. I appreciate that opposing counsel will point out I just took one paragraph from this book. All I was dealing with was general factors which caused this witness to believe in 1944 that a rise in the price of oil was thought to be inevitable. The purpose of my questioning was to establish those same factors were present in 1941. The purpose for which opposing counsel purposes to get in several pages, is to bring into the record factors which couldn't have been known in 1941.

The Court: It is doubtful to me if any of it

(Testimony of John H. Wents, Jr.)

should be read into the record here. Your witness is present and either side may, of course, interrogate him upon any proper subject. If he states now something contrary to what he has stated at some other proceeding or some other time he may, of course, be interrogated upon it. I know of no reason for putting into this record lengthy quotations from something the witness may have written elsewhere or for some other purpose.

Mr Mackay: If your Honor please, the only purpose [181] I have for doing it is that counsel picked out one paragraph. The next paragraphs here will help clarify that. Counsel, when I objected to going into 1942 prices said, "Well, it is necessary to do that," so he jumps into 1944. Now, it isn't just the price of oil that has a bearing upon the value here.

The Court: How is this going to help us in determining our present question of the valuation of these oil royalties?

Mr. Mackay: Your Honor please, I don't think that the price in 1944 does. I will have to agree with you. But I can't understand——

The Court: The witness is here and if you have anything further you wish to bring out from him on direct examination you, of course, may do so. I don't think——

Mr. Melville: I would like to be heard in response to Mr. Mackay's remark; this is clarification of the paragraph I had read into the record.

(Testimony of John H. Wents, Jr.)

The Court: I don't care to hear you at length. I don't think it is necessary.

By Mr. Mackay:

Q. Now, Mr. Wents, you were asked by counsel yesterday to get a list of the sales that you were familiar with of oil royalties in Southern California? A. Yes. [182]

Q. I understood you to say this morning you had prepared this and brought this book to court, and counsel has asked you several question upon it. I will ask you if you made a valuation of the, or for the Superior Oil Company of the Reyes Lease in the Rio Bravo Oil Field?

A. I made a valuation for the Superior oil lease, not the Superior Oil Company.

Q. Did that involve a royalty interest?

A. A royalty interest, yes.

Q. You made the valuation for whom?

A. I made the valuation for Diversified Royalties.

Q. Did it buy the——

A. Diversified Royalties bought the royalty interest.

Q. From who, Mr. Meeks? A. Mr. Meeks.

Q. What is the date of that purchase?

A. The date of that purchase was June 21, 1938.

Q. What was the purchase price of that?

A. One-quarter of one per cent in the lease was purchased for \$4,500.00.

Q. Now, had you determined the present worth on that?

(Testimony of John H. Wents, Jr.)

A. On the appraisal shown on this page I had appraised one-sixteenth of that one-quarter per cent, using one-quarter of the purchase price as the basis, and making that appraisal I used a price of \$1.54 per barrel as the future revenue. I [183] used the present value factors identically that I have used in the present appraisal. I determined the present value of that future income, and then by dividing that present value by that purchase price I found the relationship of $38\frac{1}{2}$ per cent was had.

Q. Now, did you also make a valuation in the Wagner lease?

A. The Wagner lease, yes.

Q. And that was a royalty interest, too?

A. It was a royalty interest.

Q. And was that purchased by——

A. Diversified Royalties. It was purchased by Diversified Royalties.

Q. When was that purchased?

A. April 7, 1938.

Q. What was the purchase price?

A. One-eighth of one per cent was purchased from Ten Eyck, a geologist, for a price of \$3,500.00.

Q. What was the relationship of the purchase price to the present value you determined?

A. The purchase price is 42.39 per cent of the present value.

Q. Did you make an examination of the royalty interest in the Ramsey lease? A. I did. [184]

(Testimony of John H. Wents, Jr.)

Q. Was that purchased by the Diversified Royalties? A. It was.

Q. What date?

A. It was purchased on May 16, 1938.

Q. From whom? A. L. V. Smith.

Q. At what price?

A. The price was \$2,500.00 for one-eighth of one per cent.

Q. What was the relationship of the purchase price to the present value you determined?

A. The relationship was 56.28 per cent.

Q. Did you also make a valuation of Section 7 Lease in the Coalinga oil field? A. I did.

Q. What interest did you value there?

A. I valued 1/48th of one per cent, but on the same basis of valuation for 1/4 of one per cent.

Q. Who was that purchased by?

A. That was purchased by Diversified Royalties.

Q. From whom?

A. From E. A. Parkford, an oil operator.

Q. Mr. Parkford is a rather successful oil operator? A. Yes.

Q. What was the purchase price?

A. The purchase price was \$30,000.00. [185]

Q. What was the relationship of the purchase price there to the present value?

A. The purchase price was only 39.29 per cent of the present value.

Q. Now, how many royalty interests in this book you have here, aside from those I have given you——

(Testimony of John H. Wents, Jr.)

A. There are probably 50 or 60. Here is a group of 2, 4, 6, 8, 10—20 there on that one page.

Q. 20 on that one page? A. Yes.

Q. And did Diversified Royalties buy all those mentioned here? A. Yes, they did.

Q. Approximately what was the relationship of the purchase price to the present worth?

A. The purchase price was approximately 57 per cent of the present worth.

Q. Now, Mr. Wents, I think on cross examination you were asked, among other things, that based upon the estimated oil reserves and the probable future production set forth in the stipulation, that an investor by paying a price that you say is a fair market value would derive property upon which he would get 18 per cent compound interest. I think your answer to that was you said there may be many things that would not permit such a handsome return. What do you have [186] in mind that may happen to prohibit such a fancy return?

A. I will have to explain a little bit. In timing the oil which will be produced from the various properties going into this appraisal we are governed, or the engineer is governed by certain things. In other words, it is his opinion that certain things may or may not happen. And the result is he follows the curve which he has developed and distributes that oil over that period of time, which is disclosed by the curve.

Now, in many instances interruptions can be had

(Testimony of John H. Wents, Jr.)

in the production of the oil. The control of production is not in the hands of the land owner or the royalty interest owner. It is in the hands of the operating company. They can see fit to prorate to the extent whereby the time that we figured or the time, as I figured, might be prolonged for a period again as long.

Then there are interruptions, unforeseen interruptions which might happen, say, such as an earthquake may sever the casing strings on a number of prolific producers; while it does not interfere with the oil produced, it defers production date. Then again there may come into being some other fuel or more efficient fuel than gas or oil. And as a consequence the demand might be lessened. All those things are things which would not change the ultimate recovery from the property, but may materially change the productive rate. [187] And those are the things which must be lumped into one basket and a hazard applied to take them into accord.

Q. You speak of an earthquake. Do you know, in your experience, whether an earthquake in California has ever broken the oil lines? A. Yes.

Q. When and whose property?

A. Well, subsequent to the appraisal date it happened on a portion of the Dominguez Hill. Prior to the appraisal date it had caused a serious disruption on the production on Signal Hill.

Q. Signal Hill, that isn't very far from Dominguez; is it?

(Testimony of John H. Wents, Jr.)

A. About six miles, from the center of field to center of field.

Q. Well, what happened with the earthquake subsequent to this date? What did it do to the field in Dominguez?

A. The effects of that earthquake were sufficient to cause a material change in the productive curve of the entire State of California for the year of its occurrence. That was in 1933.

Q. Well, were many wells knocked out?

A. That is what would cause and disrupt the productive curve.

Q. Subsequent to 1941 has there been any earthquake? [188]

A. In the easterly end—

Mr. Melville: I object, your Honor. That is going to situations developed in 1941. He couldn't possibly consider that in 1941.

The Court: Overruled.

The Witness: Subsequent to 1941, in the late fall of 1941 an earthquake struck the west end of the Dominguez Field, affecting almost every well on the Havenstrite-Larronde lease and affecting 10 or 12 wells, I believe, on the westerly end of the Union Oil-Callender lease, as well as certain wells on the Union Oil-Austin lease.

The Court: You don't need to go into detail. Your answer is they have had some effect since '41.

By Mr. Mackay:

Q. Was it necessary to rebuild the wells on the Havenstrite?

(Testimony of John H. Wents, Jr.)

A. It was necessary to rebuild certain of the wells on the Havenstrite.

Q. Well, now, Mr. Wents, you were asked by counsel to refer to a summary of 1942 and 1943, which bears date March 1, 1942, page 6, with respect to raise in price. Now, did you, when you made that summary, also give consideration to the future drilling of the Dominguez Oil fields?

Mr. Melville: Those are exactly the same pages I [189] objected to before and the court sustained my objection.

The Court: The question as framed, the objection to it will be overruled. You may answer.

The Witness: Yes, I did.

By Mr. Mackay:

Q. What was your comment at that particular time about that?

A. That the leases of the Dominguez Estate Company and Carson Estate Company on Dominguez Hill had been more or less fully developed and there would be very little future drilling on those leases.

Mr. Mackay: I think it is all, your Honor.

The Court: Will there be any recross examination?

Mr. Melville: Yes, your Honor.

The Court: You may proceed.

Recross Examination

By Mr. Melville:

Q. Are the stipulated figures, Mr. Wents, your

(Testimony of John H. Wents, Jr.)

own figures as to the probable future production rates?

Mr. Mackay: If your Honor please, we have stipulated what the future, probable future production is. We had many conferences on it and we arrived at it. I don't understand the purpose of this question.

The Court: The objection may be overruled. He may answer. [190] Do you understand the question?

The Witness: Yes, I do.

The Court: Answer it.

The Witness: The answer is yes.

By Mr. Melville:

Q. You mentioned on redirect examination the matter of operating companies. Who are the operating companies involved in our leases in this case?

A. With respect to the Reyes lease, the Union Oil Company, Dominguez Oil Fields and Shell Oil Company are the operators. With respect to the DeFrancis lease, the Tidewater Associated Oil Company is the operator.

Q. With respect to the largest lease, Reyes lease, are not those operating companies considered to be tops, the best that are operating in Southern California? A. You will have to be more——

Q. They are entirely competent operators; aren't they?

A. In the opinion of some people I would say yes. It depends on what view you take of the picture. I say yes.

(Testimony of John H. Wents, Jr.)

Q. You consider those companies that are operating the Reyes lease to be entirely competent?

A. They are competent.

Q. Mr. Wents, what do you mean by a field that is fully developed to settle production?

A. By the statement "fully developed to settle production" I am assuming, in making that statement, that the necessary wells have been drilled upon the property and the decline rate has reached a constancy; it is not erratic one way or the other. There is a constancy in the declining rate on the property.

Q. Are all the leases involved in our case on oil property that is fully developed to settle production?

A. No, they are not.

Q. Do you consider it good practice, Mr. Wents, to apply your same discount factors of 10 per cent and $43\frac{1}{3}$ per cent in valuing the oil properties that are fully developed to settle production, as you do in valuing oil properties of undeveloped oil reserves?

A. In certain cases I do; in certain cases I do not.

Q. Can you be more specific?

A. In the specific instance you have reference to here I happen to be engineer, not only for the Dominguez Estate Company, but for each of the companies operating on the Dominguez Estate property. I know what their plans for future development are, because they are my plans. I engineer the operation of the well from the com-

(Testimony of John H. Wents, Jr.)

mencement of its location through to its completion.

I engineer the production on that well after completion with the full knowledge on the part of the Dominguez Estate Company I am so doing, and their consent. I am working for [192] both parties for the betterment of both. Under those circumstances I believe I can set forth a development program, as well as a program which will anticipate certain productions at times with sufficient relation to the set fair market value as I do on any.

Q. If the circumstances were different and you were not the geologist and engineer on the property and so forth and so forth, then do you think you would be justified in using your same 10 per cent and $43\frac{1}{3}$ per cent in appraising undeveloped properties, as you use in appraising the developed properties?

A. The discount I would choose to use would be entirely based upon my knowledge of what the operator would be likely to do, as well as the materials and condition of the lease. I may or may not use the same; that would be just a case of judgment on my part, what I would use.

Q. Tell me whether you have, ever since 1936, when you adopted this formula, used any other formula.

A. For the valuation of oil royalties and property interests the basic formula, this is the basic formula. I have sometimes shortcutted the formula by assuming an average discount comparable to my

(Testimony of John H. Wents, Jr.)

knowledge of what might be expected, and have sometimes also converted to barrels, in royalty barrels per day, and things like that. Actually it comes back to the same thing. It is only because I have had a lot of [193] experience in dealing with properties which are quite similar that would allow me to make the deviation. In any of my written reports, prepared for any of my accounts, I have not deviated, that I know of.

Q. Tell the court, if you will, about any specific case where you have deviated.

A. I can't remember any case where I have deviated, offhand.

Q. What oil fields were these various leases in that, upon redirect examination, you testified as to sales running from \$2,500.00 all the way up to \$30,000.00?

A. Those fields, that were mentioned there, were Rio Bravo, Coalinga and I think Huntington Beach; I am not sure.

Q. Is Rio Bravo a developed oil property or was it at the time you made that appraisal in 1938?

A. It was developed to the extent where I felt assured the development would take place along certain lines.

Q. Would you say it was a fully developed property up to settle production, up to 1938?

A. No, I could not answer that question.

Q. You can answer it yes or no.

A. I couldn't answer. I am sorry. I couldn't

(Testimony of John H. Wents, Jr.)

answer it without explanation. In other words, the property was not fully developed or certain of these properties were not fully developed. Others of them were in the Rio Bravo [194] Field as of that time.

Q. Take this Superior-Ruhl lease, now, that you valued in 1938—rather, a sale was made in 1938 for \$4,500.00. That is on the Rio Bravo property?

A. Yes.

Q. On the particular property where that lease was, would you say that the oil property had been fully developed to settle production in 1938?

A. I am trying to remember back to that time. I believe the Ruhl lease was developed by three wells as of the time it was appraised. And that those three wells constituted the total drilling to be expected under the terms of the lease as of that time, as well as the other lease, the Ramsey lease, that was developed to a slightly greater tenancy. I am trying to place myself back to 1937 or '38 there, and the maps.

The Court: We will suspend at this time until 2:00 o'clock.

(Whereupon, at 12:30 o'clock p. m., a recess was taken until 2:00 o'clock p. m. of the same day.) [195]

Afternoon Session 2:00 p.m.

JOHN H. WENTS, JR.

resumed his testimony as follows:

(Testimony of John H. Wents, Jr.)

Recross Examination—Resumed

By Mr. Melville:

Q. Mr. Wents, my attention has been called to a qualification you made this morning, in answer to my question about your testimony in the United States District Court case. I believe you testified you had appraised that at roughly \$10,000.00, that oil property? A. Yes.

Q. When I asked you if it wasn't true that the jury brought in a verdict of \$20,000.00, or twice your appraisal, you made some qualification. I would like to clear it up for the record.

A. I would like to clear it for the record. In that particular instance there were two things involved, one was the value of the equipment, the physical equipment on the well; the second was the value of the oil reserves. For some reason the two had not been taken simultaneously. In other words, they took the oil and at a later date found that in taking that oil they should have also provided for the physical equipment.

As a consequence, there was a semi-confusion or a [196] confusion in the proceedings to the extent that two values were allowed to be set up, when only one reasonably could be set up, because the value of the physical equipment as of the date of reserve exhaustion is a very negligible thing.

The Court: I suggest we not go too much into detail on the suit that has been tried. Make your explanation rather brief, if you will.

(Testimony of John H. Wents, Jr.)

The Witness: (Continuing) In so doing they sat up a value for physical equipment, which was far out of proportion to my value. That accounts for the difference in my appraised worth of the property and the judgment which might have been rendered.

By Mr. Melville:

Q. Did you value only the oil properties there or all the properties, including the equipment?

A. I am valuing all the properties, including their equipment; those which are coming to trial.

Q. Those which are coming to trial?

A. One of them has been tried; others are still in the process.

Q. All right. Mr. Wents, about these sales that you testified to on recross examination, we were talking about the Superior-Ruhl lease in the Rio Bravo Field and others following that. Do you recall the testimony? A. I believe I do. [197]

Q. Which of those fields were fully developed to settle production at the time of the sales?

A. The specific properties that we were concerned with or we talked about, in my opinion, were fully developed at the time of the sales and production was settled by virtue of the exercise of curtailment upon the properties. Those properties were producing in accord with the Umpire's formula.

Q. Your testimony, then is they were all fully developed to settle production?

(Testimony of John H. Wents, Jr.)

A. The properties that you have mentioned, the Rio Bravo.

Q. How about the Coalinga oil field?

A. The Section 7 lease that I testified with respect to was partially developed, but, in my opinion, the proven area had been established.

Q. Will you go ahead and state which of the others you testified to were fully developed and which were not?

A. The list would have to be read off to me. I believe that Mr. Mackay has the book I was using.

Q. Was the Wagner lease on fully developed property? A. Yes, it was.

Q. How about the Ramsey lease?

A. Fully developed. We did not use that one.

Q. What depths were these properties producing from that you testified to? [198]

A. Which properties?

Q. The same ones that Mr. Mackay asked you about on redirect examination?

A. Are those the ones we have just discussed now, or others?

Q. The Ruhl lease on the Rio Bravo oil field, the Wagner lease on the same field.

A. 11,000 feet, roughly.

Q. Isn't it true, Mr. Wents, that when you are producing from such an extreme depth as that it is more hazardous than if you are producing from, say, 5,000 feet?

(Testimony of John H. Wents, Jr.)

A. I can't understand your question there. What do you mean by "more hazardous"?

Q. Aren't there more dangers of not getting the oil that is in the ground out of the ground if you are trying to pull it up from 11,000 feet than if you are only trying to pull it up from 5,000 feet?

A. No.

Q. Were these same properties rather new wells in 1938?

A. The wells were probably two, three, four and five years old.

Q. They were still in flush production?

A. Production on those properties was curtailed. 330 barrels a day was the daily rate, and they had initial [199] production of several thousand barrels.

Q. I understand the production was curtailed. If the production hadn't been curtailed, the fact the wells were fairly new would have given flush production; wouldn't they?

A. In that case we have no reliable decline curve to go against, and as a consequence, we estimate by volumetric methods the recoveries.

Q. In summing up your testimony then, Mr. Wents, is it true that in making valuations both before and after 1936 you have used in all cases a 10 per cent discount factor and then a $43\frac{1}{3}$ discount factor?

A. My valuations had been for the purpose of setting forth my opinion with respect to fair market value; that is the procedure I have followed.

(Testimony of John H. Wents, Jr.)

Q. That has been true whether it was during depression or boom times?

A. It doesn't make any difference.

Q. Mr. Wents, if the prospective or hypothetical buyer that you had in mind when you valued these properties had paid the three million, some thousand dollars you have testified to, as the fair market value, if he had paid that in 1941 when would he have received all of his money back?

A. I don't know.

Q. Don't we have in evidence an exhibit that would enable you to express an opinion as to that?

A. No. We have in evidence an exhibit which shows the payments——

Q. Probable future?

A. ——which would accrue from that. However, there is a lot of difference between the payments which might accrue from that and what he might have had back in the way of his money, because the income tax drag on those payments would have been terrific.

Mr. Melville: No more questions.

Redirect Examination

By Mr. Mackay:

Q. Mr. Wents, are you a member of the American Petroleum Institute? A. I am.

Q. Do you belong to any other professional society?

A. I belong to the American Association of Petroleum Geologists.

Q. You said you did not get a degree. How many

(Testimony of John H. Wents, Jr.)

credits did you get towards that, do you remember?

A. In the geological and allied engineering and petroleum engineering sciences approximately 130 or 140 hours of credit, against 45 hours which are required of a degree.

Mr. Mackay: That is all.

Mr. Melville: Mr. Wents, why didn't you get a degree? [201]

The Witness: Mr. Melville, I was interested in getting out in the profession and making my way. As a consequence I attended Stanford for four years and attained the ground work. Immediately upon completing that I went to work in the oil industry. After working in the industry approximately seven years I went back and took additional work, during a period of five years, amounting to almost the same course I took in college, except in graduate work at U.S.C. There were a number subjects required of certain college degrees. I didn't see where they were going to help me much.

Mr. Melville: That is all.

(Witness excused.)

Mr. Mackay: I will call Mr. Paine.

PAUL PAINE

called as a witness by and on behalf of the Petitioners, having been first duly sworn, was examined and testified as follows:

(Testimony of Paul Paine.)

Direct Examination

The Clerk: State your full name for the record, please.

The Witness: Paul Paine.

By Mr. Mackay:

Q. Are you a resident of Los Angeles?

A. Yes, sir. [202]

Q. What is your occupation, Mr. Paine?

A. I am an engineer and I work in the oil fields.

Q. Are you a graduate engineer?

A. Yes, I graduated from the Massachusetts Institute of Technology?

Q. Will you please relate briefly your educational qualifications?

A. That was in 1905 I came west and for several years worked in the mines and did field geological work for the United States General Land Office in the prosecution of land frauds and in connection with the classifications of mineral lands until 1908.

Then I entered the oil fields, and since then I have been continuously connected with oil field operations.

Until 1917 I worked in the California fields. The latter part of that period as field superintendent of Honolulu Oil Company. I then went to Oklahoma with the Gypsy Oil Company. The operating unit in mid-continent area of Gulf Oil Corporation.

In 1921 I cut loose on my own hook, and since then I have had no regular continuing corporation

(Testimony of Paul Paine.)

connection except those small companies in which I have a substantial interest, and also except several years I was on the Board of Directors of Union Oil Company, and one year, from the middle of 1922 until the middle of 1923, when I was vice president [203] of the Shell Company of California, in charge of its production operations.

I should add I do have two other connections. For the Kern County Land Company, I am on its Board of Directors, and am concerned with its oil affairs. And for the Bank of America, I am the consulting petroleum man, which means chiefly passing on oil loan applications.

My partners and I drill wells and produce oil in a small way. And in addition to that I have an engineering practice which is concerned almost entirely with the valuation of oil properties and of oil companies.

Q. What is the form and scope of your valuation consulting engineering practice, Mr. Paine?

A. Well, that takes several forms. First, in connection with loans where the value of a property is related to the merit of it as security for a loan and its capacity to pay back the loan. Work of that kind I have done for the California Bank, Bank of America, the Chase National, the Equitable Life Insurance Society.

A second class of work is that which is done for the oil companies themselves in connection with the sales and purchases of properties, mergers, dissolutions and a variety of work where not in spe-

(Testimony of Paul Paine.)

cifically it is desired to bring in an outside engineer either to supplement an engineering staff or to act as referee. I have done work of that character [204] during recent years for Shell Company, Honolulu Oil Company, Pacific Western Oil Company, Standard Oil Company, Indiana, Pan American Petroleum, Wolverine, Midwest Oil Company, Amarado Petroleum Corporation.

The third class of work is for the bankers in connection with the issuance of securities and particularly with reports that are prepared for their deals of that kind and for the papers which are required by the Securities and Exchange Commission and the certificates which must go to the Securities and Exchange Commission. Work of that kind I have done for Morgan, Stanley & Company; Dillon, Reed & Company; Smith, Barney & Company; Blythe & Company, Inc.; Dean Witter & Company.

Another kind of work not so closely related to that is the consulting and advisory work which one does for the land owners or lessors who occupy the lease or position in contrast with the lessee position, which the operating company has. Work of that kind I am doing or have done recently for Kern County Land Company, the Porter Ranch, Pleasant Valley Farm Company, Metropolitan Life Insurance Company, Hillcrest Country Club, Twentieth Century-Fox Film Corporation.

Q. Now, in your experience as a consultant, engineering consultant, have you had occasion to make valuations in determining fair market value

(Testimony of Paul Paine.)

of properties for purchases and [205] sales?

A. Yes.

Q. You have done quite a bit of that, haven't you, Mr. Paine?

A. Yes.

Q. You have testified on many occasions, have you not, as to the fair market value of properties?

A. No, I have not.

Q. You have never testified?

A. This is my fourth appearance in court in 15 years. Except for a series of appearances for the Attorney General and District Attorney in connection with these criminal prosecutions of people fraudulently selling lands represented to be oil lands out of that group, which I did as a public service, I think this is my fourth appearance in court in 15 years.

Q. Were you employed to make an appraisal to determine the fair market value of the oil royalty interests of the Dominguez Estate Company on June 5, 1941?

A. Yes.

Q. You have made that appraisal; have you?

A. Yes.

Q. Are you familiar with the stipulation that has been filed in court here and the exhibits?

A. I think I am. I have been supplied with copies of [206] the stipulation.

Q. You made an analysis of the information therein contained?

A. Yes.

Q. You have made other analyses, too, have you, of other things that may have a bearing on fair market value?

(Testimony of Paul Paine.)

A. Of this property?

Q. Yes.

A. Yes. I have known the property for some time and have been on it.

Q. You have been on it?

A. Yes. Oh, yes.

Q. How long have you known the property, Mr. Paine?

A. I can recollect walking over it before there were any derricks on it; that was in 1922. Long intervals elapsed after that when I wasn't on it. I don't mean I have been on it a great deal; I have been on it a good many times.

Q. Can you tell the court what is the basis of your valuation?

A. The basis of my valuation was an estimate or opinion of the meeting ground of a willing buyer and a willing seller; that is, a buyer that was willing and able to buy and a seller that desired to sell, that wasn't forced to do so, with both of those having full knowledge of the facts. Along with that was my knowledge of the property and the [207] specific data supplied by you in the stipulation.

Q. You have recently been down to the property; haven't you?

A. Yes, about six weeks ago, I think, I was there; about six weeks ago it was. And I was on the property several times in the spring of 1941.

Q. You were? A. Yes.

Q. Now, Mr. Paine, will you tell the Court just

(Testimony of Paul Paine.)

what factors you take into consideration in arriving at your opinion as to the fair market value of the oil royalties of the Dominguez Estate on June 5, 1941?

A. I took into account your stipulation, first, the estimate agreed to of the oil reserves and of the revenue that would provide.

I also reconstructed my opinion of how the buyer and the seller would view this property and the various factors which would be taken into account by them, namely, the daily production which the property was then producing and a measurement of—not a measurement, but an estimate of how they would view the value of that oil in the ground per barrel and of the number of years it would take for them to get this money back. These are all indices used by buyers and sellers in their transactions. I endeavored to reconstruct the conventional persons, the willing seller and the [208] willing buyer, how they would view this in making the deal.

Q. Now, you speak about the daily production. Will you please tell the Court what significance that average daily production has in arriving at the fair market value between a willing seller and a willing buyer?

A. Buyers and sellers of properties use that as one means of measuring the merits of property, so many dollars of the daily barrels of production; if a property has 10 barrels a day of production, to a certain interest and if they should consider

(Testimony of Paul Paine.)

that to be worth \$1,000.00 a barrel, the property is measured as being worth \$10,000.00. Just as real estate is directly dominated as having a value of so many dollars per front foot. It is a short cut. It is one that is used widely.

Q. Did you also make an engineering appraisal?

A. Only insofar as I took the official stipulation.

Q. That is what I mean.

A. And followed it. I followed that out and converted that into a so-called engineering or analytical valuation. Then I converted that into an expression of market value. And after I had done that—I haven't much respect for it, but I did it.

Q. Do you remember what value you got in doing that? In other words, Mr. Paine, what I would like to have you do is tell the court how you arrived at these fair market values. [209]

A. I made this so-called engineering appraisal in which I discounted the anticipated future revenue as it had been stipulated, using a 5 per cent factor. And then I observed, however, that no allowance had been made here in the stipulation for the effect of income taxes.

Q. Well, the stipulation was not intended to arrive at any value, just to put down some indices of that.

A. No. After all, the stipulation, all of this process is not a valuation. It is simply an estimate of future profits and their present worth. So I ascertain a present worth based upon a 5 per cent discount factor, which arrived at a figure.

(Testimony of Paul Paine.)

Then I applied a further deduction for the effect of income taxes, which would be levied against this, which was entirely an estimate, and which, in my instance, was 30 per cent deduction.

Now, with that figure arrived at, there was an estimate, an engineering estimate of the present worth of the anticipated future profits, which this property would provide after paying the costs and the income taxes.

Now, I converted that then to an estimate of market value by multiplying by .625. My reason for .625, that is, 62½ per cent of that—my reason for doing that was I have observed in a great number of instances the actual market value of a property seems to end up in the range between 60 [210] and 65 per cent of the valuation which one gets by applying a discount factor of 5 per cent or 6 per cent to the anticipated future profits. That is a general rule; there are many variations from it. That was my engineering appraisal.

On that basis I arrived at a figure of \$2,720,965.00. Shall I go ahead?

Q. Go ahead and explain it.

A. The property at that date was producing or had the first five months of 1941 produced an average of 1520 barrels a day net royalty oil to the interest of the lessor.

Now, I consider the value of that to be in the range from \$1,500.00 to \$1,800.00 per daily barrel; that is, \$1,650.00. It amounted to \$2,508,000.00.

(Testimony of Paul Paine.)

At \$1,800.00 per daily barrel it amounts to \$2,700,000.00.

Another method of estimating the value of a property is at a rate per barrel in the ground. I considered the value to be 40 cents per barrel against the stipulated oil reserves of 7,992,871 barrels.

Q. Why do you do that, Mr. Paine?

A. Because you had stipulated that.

Q. I know, but what do you mean by 40 cents per barrel—why do you do that? Let it go.

Mr. Melville: I would like to have it answered.

Mr. Mackay: I withdraw the question. [211]

By Mr. Mackay:

Q. You may proceed with your answer.

A. Another method of ascertaining the value of a property is the percentage of the ultimate return. Very often the buyers of property are not so fussy about when the oil is coming in, they don't pay any attention to these engineering estimates. If they estimate the property is going to return so much money over its entire history, they will pay on the basis of getting three for one, or two and a half for one or four for one, or five for one, depending upon the circumstances. Now, at a return of four for one the value of this property would be \$2,257,495.00.

At a return of three for one, on the stipulated return to which you had agreed to, the return would be \$3,009,993.00.

Another method of measuring the value of such

(Testimony of Paul Paine.)

properties is on an annual pay-out basis. The buyer likes to figure on how soon will he get his money back. Two courses are followed there. He may take the current rate of revenue and multiply it by so many years, or he may take into account this decline which is almost inevitable in all oil properties after they have passed their peak of production. [212]

Now, the average return per barrel, according to your spitulation, is \$1.13 a barrel. And the rate of production was 1520 barrels per day. So that at that rate of production, multiplied by 365 days, arrives at an average annual production of 554,800 barrels, which at \$1.13 would indicate an annual return of \$626,924.00, provided there were no declines or changes in the rate of production.

Now, that rate multiplied by five years equals \$3,134,620.00. At four years it equals \$2,504,896.00.

On the other hand, when considering that point of view, a buyer instead of multiplying the present annual rate by so many years will draw up a projected decline rate and see where that is going to bring him out; following some pattern.

Now, on the pattern which I think would have been followed in this property and on a seven-year pay-out basis, assuming he received \$600,000.00 during the first year and there was a gradual decline, a seven-year pay-out would have returned to him \$3,252,000.00. All without any consideration of the effect of income taxes.

Now, there is another method of appraising properties which may be applicable here. It is the other

(Testimony of Paul Paine.)

one, I think, could even be considered here, although there are other methods of valuing property which would not be pertinent here; that is the acreage per cent. We have a unit which registers the rating value of one per cent of the oil from one acre. Thus if I am buying one percent of the oil from 40 acres, I am buying [213] 40-acre per cent. There is much trading done using that unit. Using a figure of \$250.00 an acre per cent brings us out with a value on that basis of \$2,711,740.00.

I want to add that I don't think that consideration has any merit here. The result is I had all these valuations representing my conception of the meeting ground of these hypothetical persons, and I wrapped them up—did not average them, but just weighed them mentally and landed on the figure of \$3,000,000.00 for the property.

I confess I didn't like it. I wanted to come out with something less broad, either something over \$3,000,000.00 or under. But an effort to do that failed. I should add, however, that if I were to deviate from that either way I should have made it three million one rather than two million nine.

Q. That, in your opinion, represents the fair market value of the royalty interest of the Dominguez Estate Company on June 5, 1941?

A. That is my estimate of that, yes.

Q. Now, Mr. Paine, may I ask you, you spoke about the Kern County Land Company, that is a company up in Kern County; isn't it?

A. Yes.

(Testimony of Paul Paine.)

Q. It owns lands? A. Yes. [214]

Q. It has royalty interests? A. Yes.

Q. It has leased its land? A. Yes.

Q. You have passed upon the values of oil royalties in a great many instances; haven't you?

A. Yes.

Q. You made appraisals for the buyer and the seller or for banks or anybody interested; haven't you? A. Yes.

Q. Will you tell the Court, have you had experience in valuing stocks and securities?

A. Yes. I have been concerned with the values of oil securities particularly.

Q. You did considerable work along that line?

A. Yes, I have.

Q. For banks and for the underwriting houses?

A. For the underwriting houses; not for the banks. Rather for the investors and the underwriting houses, for the investment trusts.

Q. Now, you made a statement there, speaking about the average daily production of 1520 barrels in 1941. I think you stated that you assigned a value of \$1800.00 per barrel. Do I understand that correctly, Mr. Paine?

A. Yes. I spelled it both with \$1650.00 and \$1800.00. [215]

Q. I see. Well now, why did you use \$1650.00 and \$1800.00? Can you explain to the Court how you arrived at that?

A. The transactions that had taken place if put back into that term showed that that was a proper

(Testimony of Paul Paine.)

index. I mean we were at times buying royalties on the basis of a thousand dollars a barrel and other properties were selling on the basis of \$500.00 a barrel. The unit per barrel varied widely under different circumstances. I don't know that I can for you mathematically——

Q. I don't want you to. I want a question of judgment.

A. Why I used \$1650.00 or \$1800.00 I can't tell you, any more than the real estate man can tell you why this business property out here is worth \$700.00 a front foot. The figures I used reflect what I consider to be the units that would have been used by the buyers and the sellers on a transaction at that time.

Q. You obtained them from your experience and use and your judgment; isn't that correct?

A. It was based on my experience and observation, yes.

Q. You have brought and sold or assisted in the purchase and sale of royalty interests on that basis; haven't you?

A. I have bought and sold them myself. I own them and I am concerned with them, yes. [216]

Q. You have sold them on the basis of the average daily production at a certain price; haven't you?

A. That is one of the measures we use when we are considering what we are going to ask for it. I don't think it is a conclusive one, by any means. I don't think any of these courses is the final answer.

(Testimony of Paul Paine.)

I think they all represent things which would be taken into consideration by a man who is going to make a deal.

Q. Then do you think that an informed buyer would take all those things into consideration?

A. I think so.

Q. As well as an informed seller?

A. Yes. A smart buyer will say, "How much is that per daily barrel?" Oh, yes.

Q. You know that is what the buyers generally ask; don't you? A. Usually.

Q. Do I understand that your value of \$3,000,000.00 for your royalty interest of the Dominguez Estate Company on June 5, 1941, is based upon all these matters you have taken into consideration, and you have weighed them and that is your best judgment, based upon them?

A. Yes, that is it exactly.

Q. And I understand you to say your analytical appraisal, that you did take the estimated oil reserve and the probable [217] production; did you not?

A. Oh, yes, in all these computations I did not deviate as far as reserves and revenue and so on from your stipulation.

Q. Now, Mr. Paine, did you also make an appraisal of the royalty interest of the Carson Estate Company?

A. Yes. I considered that to be worth \$283,000.00.

Q. Will you please tell the Court how you arrived at that?

(Testimony of Paul Paine.)

A. Well, I arrived at it pretty quickly. I took the pattern of expected future return and I think I took a six-year pay-out figure. I didn't go through all of these processes on the Carson property. I remember that one reason for that was at that time I did that I didn't have your stipulation with respect to the barrels in the Carson Estate, and so I relied upon the estimate of revenue. Since then, since getting all these figures I have reviewed it and I think if anything I would give it a lower figure, but not of any great amount.

Q. I see. Mr. Paine, what, in your opinion, is the fair market value of the oil royalty interests of the Carson Estate Company?

A. \$283,000.00.

Q. Now, Mr. Paine, have you also made an appraisal of the stock of the Dominguez Estate Company?

A. As of that date, yes. [218]

Q. As that date; that is what I mean; as of June 5, 1941.

A. Yes; \$420.00.

Q. What did you take into consideration in arriving at that value?

A. I took into consideration your stipulation with respect to other assets.

Q. Stipulation and the exhibits, you mean?

A. Yes. And my appraisal of the value of the oil properties. And I also took into account the earnings record of the company.

Q. Mr. Paine, the stipulation and the exhibits, particularly the exhibits attached to the stipulation show the balance sheets and profit and loss state-

(Testimony of Paul Paine.)

ments for a number of years of the Dominguez Estate Company, and as well its dividend record and earnings and what not. You took those into consideration; did you not? A. Yes.

Q. Well, how did you arrive at the value you said that you gave for the Dominguez Estate Company stock?

A. I followed two courses. First, I reconstructed me a balance sheet of my own. And second. I made a study of the earnings of the company and arrived at two estimates. And I took the average of these two.

Now, first as to the balance sheet, I arrived at [219] the value per share of this company, based upon the balance sheet record of a current asset. I rated those as having a value of 90 per cent of the balance sheet statement.

The Court: Pardon the interruption. What is the balance? Is it in these exhibits? Which one is it?

Mr. Mackay: I think it is——

Mr. Melville: 1-R.

The Witness: And I arrived at a value per share for each of these elements in the balance sheet. First, the current assets, which I rated at 90 per cent. And that divided by the outstanding shares, 10,499, equals \$74.00.

The stocks and bonds I rated at 70 per cent; equivalent to \$76.00 per share. The ranch real estate I rated at 40 per cent, which is equivalent to \$62.00 per share. And the other real estate at

(Testimony of Paul Paine.)

50 per cent, equivalent to \$78.00 per share.

The oil property, I went back to the analytical appraisal of the discounted present worth of future earnings at 5 per cent; equal to \$6,218,349.00.

The Court: Pardon the interruption.

The Witness: Yes, indeed.

The Court: I am not sure I understand what you mean by taking stock and bonds, ranch real estate and so on at 50 per cent.

The Witness: I am sorry.

The Court: What figure do you mean, of the book [220] values or of the stipulated fair market value?

The Witness: The stipulated fair market value of stocks and bonds is set down here as \$1,141,270.00.

The Court: You took 70——

The Witness: I take 70 per cent of that.

Mr. Melville: Your Honor, the stipulation of the parties is that this is the fair market value.

The Court: I know. He is telling how he analyzed it. That is the reason I was trying to follow them.

The Witness: Should I follow what counsel——

The Court: You let counsel inquire. He may cross examine you a little bit.

The Witness: At 70 per cent, that equals \$798,748.00, divided by the outstanding stock which is equivalent to \$76.00 a share. The oil property on a 5 per cent discount factor, applied to your agreed future earnings, equals \$6,219,349.00. I assumed there would be a further 25 per cent provision to

• (Testimony of Paul Paine.)

come out of that, to meet the State and Federal income taxes. This reduces it to \$4,664,412.00, which per share for the 10,499 shares would equal \$444.00.

Now, it has been my experience in situations of this kind that these appraisals, when put in terms of stock of a company which owns the property, are found to be from $2\frac{1}{2}$ to 4 times what the stock actually sells for. And I used particularly here as an index a transaction which had happened [221] not long before then as to the Dominguez Oil Fields Company, a corporation, where a similar issuance of stock showed the stock to go out on a basis of $2\frac{1}{4}$ or $2\frac{1}{2}$ to one.

So I applied a 50 per cent reduction to that, making the stock of the company, on my balance sheet, \$222.00 for its oil interests. Now, the total of the interest outside of the oil would be \$290.00. I reduced that by 10 per cent to cover what would be the cost of distributing that stock and bringing it out into the open and making a market for it. That leaves the stock value per share for all the interests, aside from oil, \$261.00, added to \$222.00, equals \$483.00; against which there were liabilities equivalent to \$28.00, leaving a net value per share of \$455.00. That is one way of considering the value of that stock.

A second way is to consider the earnings of the stock and how that would be reflected in its market value, because we are able to compare this with other somewhat comparable companies and the way those stocks were behaving at that time.

(Testimony of Paul Paine.)

Now, the earnings of the company before depletion for 1940 was \$47.80. And the earnings for the company in 1941 were \$47.91 per share. So I assumed that the investor would take \$48.00 per share as the annual earnings; multiply it by eight times to ascertain his measure of the value of that stock, which equals \$384.00 per share. [222]

I then took the average of \$384.00 and of \$455.00, which is \$419.50, and called it \$420.00 a share.

Q. Is that your estimate of the fair market value?

A. That is my estimate of the fair market value of the stock at this time.

Q. You mentioned, I think, Mr. Paine, that the Dominguez Oil Fields Company—will you tell the Court what that is and what transaction you are referring to?

A. That is an entirely separate company, has no relation to the Dominguez Estate Company. It is a lessee or operating oil company which owns along with the Union Oil Company a half interest in the lessee position on the three properties which adjoin this Reyes lease.

In the Reyes lease it owns a smaller interest, along with the Union and the Shell. Late in 1938, I think it was, the Mills Estate disposed of a lot of that stock. I was hired by the underwriting group to make an appraisal of it, and to advise them in the course of the financing.

I found at that time that my estimate of the future profits which that company was going to

(Testimony of Paul Paine.)

obtain per share was equivalent to \$100.00 per share. And that discounted on a 6 per cent pattern over the future was equivalent to about \$65.00 per share. In other words, if the income tax didn't change and if the price of oil continued the same and the costs continued in the pattern which I had made, why, the person who [223] paid for a share of the stock could expect to see \$100.00 of profits and earnings come into the company throughout its history per share.

And that discounted at 6 per cent over this period and at the anticipated rate of return, that is equivalent to \$65.00 per share. That stock was actually sold by the Mills Estate to the underwriting group for \$32.50 and redistributed by the broker for \$36.00 per share. The brokers were Dean Witter, Smith, Barney, Lehman Bros., and one or two more. That is what you are asking about?

Q. Yes, Mr. Paine. Now, did you also make a valuation or an appraisal of the stock of the Francis Land Company?

A. Well, I can relate that in a short time. I think Francis was worth just as much as Dominguez and no more. In theory there is 10 per cent difference there. One could come to the conclusion that Francis' stock, by reason of its holding in Dominguez—you see, ownership of stock in Dominguez Estate Company is almost the only asset that Francis had. But when that stock reaches the market it would be my opinion it would sell for no more than the Dominguez, because it is further removed

(Testimony of Paul Paine.)

from its source of revenue, which is entirely the income, or almost entirely the income of Dominguez.

Q. When you got dividends it could be subject to tax to a 15 per cent of the dividends, so that would further reduce its value, wouldn't it, Mr. Paine? [224]

A. It would reduce its income relatively, yes.

Q. That is what I mean.

A. Yes. When you get to taking——

The Court: I am a little hazy here as to what Francis has. Francis owns half of Dominguez stock; is that right?

Mr. Mackay: Francis owns 5,499 shares out of 10,499.

The Witness: A little over half.

The Court: You say the Francis stock is worth exactly the same as the Dominguez stock. Do you mean that on a prorata basis or what?

The Witness: Per share.

The Court: Per share?

The Witness: Yes. What Francis had was had outstanding 5000 shares of stock. And it owned 5,499 shares of Dominguez. So far each share of Francis you would own 1-1/10th shares of Dominguez. Am I correct?

Mr. Mackay: That is right.

Mr. Melville: That is right.

Mr. Mackay: Your Honor, please, could we take a recess?

The Court: Yes. We will suspend at this time for a brief recess.

(Testimony of Paul Paine.)

(A short recess was taken.) [225]

Mr. Mackay: You may cross examine.

Mr. Melville: Do you want to make a stipulation at this time?

Mr. Mackay: Yes. Your Honor, please, in order to shorten the time of the trial, the parties have agreed to stipulate that the fair market value on June 5, 1941, of the royalty interest of Carson Estate is \$285,000.00.

Mr. Melville: It is so stipulated, your Honor.

The Court: In your exhibits, what figures does that take the place of?

Mr. Melville: That was left blank. That was at issue, one of the questions we are trying to prove, 3 (c).

The Court: Off the record.

(Discussion off the record.)

The Court: On the record.

The substance of your stipulation, gentlemen, is that on Joint Exhibit 3-C the fifth item, following oil properties, which shows on the exhibit as at issue, you now substitute the amount which you have?

Mr. Mackay: That is quite all right.

Mr. Melville: That is correct, your Honor.

The Witness: What was that amount again?

Mr. Mackay: \$285,000.00.

The Court: Is there any objection to my putting that into the exhibit? [226]

Mr. Melville: I think it would be advisable, your Honor.

(Testimony of Paul Paine.)

Mr. Mackay: I think it would be advisable, your Honor.

The Court: Very well. \$285,000.00. All right. Thank you, gentlemen.

Mr. Mackay: You may cross examine the witness?

Cross Examination

By Mr. Melville:

Q. Mr. Paine, what is fair market value?

A. That is a legal term. I do not know what it is. I am guided in my own estimates. My use of the term in my work, I accept as fair market value my estimate or opinion of the meeting ground at the specific date of a buyer, who is willing and able to buy, and a seller, who desires to sell, but is not forced to do so; with both of these having full knowledge of the facts.

Now, I am sorry not to respond to your question. I am not a lawyer. I can't answer it. It is exclusively a legal term.

Q. Do you consider it to be a legal absurdity?

A. Not completely. I think many of these legal efforts to fit one definition to a great many circumstances leads into situations which approach the absurd. No, this conception of the meeting ground of these two persons of that date is [227] far from absurd. If I understand what you mean by absurd.

Q. My question wasn't as to your application of fair market value to the facts in this case, or you use of it in this case, but I am just wondering if

(Testimony of Paul Paine.)

you don't fundamentally believe that fair market value is a legal absurdity?

A. I wouldn't go that far, no.

Q. You never went that far?

A. No, I wouldn't say I went that far; oh, no.

Q. Mr. Paine, have you ever written a book?

A. "Would that my enemy would write a book."

I have written two books; one on the drilling of oil wells and the technical methods of producing oil, and the second book on the subject of the valuation of oil properties.

Q. Is this the book you wrote, Mr. Paine (indicating)?

A. Yes.

Q. When did you write that?

A. That was along in '41, '42.

Q. Just about the period we are dealing with?

A. Yes; a little bit later, I think.

Q. How much later?

A. Not over a year later.

Mr. Mackay: I think it says 1942.

The Witness: August 19, '42.

By Mr. Melville:

Q. That is when it was published. When was it written? [228]

A. In the year preceding that.

Q. 1941?

A. And it was spread out: Now, I wrote various papers at one time and another, and then one day I sat me down and wrote an article on the subject of fair market value. And then I thought, "Why

(Testimony of Paul Paine.)

take a lot of bites at this apple? Why don't you write a book?" So I did.

Q. Would you like to tell the Court what you think about fair market value and what you said about it in your book?

A. No, I wouldn't like to.

Q. Supposing you do it, anyway.

A. There are a great many references. Sit back and relax, because it is going to take many pages.

The Court: I don't believe I want the witness to read the book to me.

Mr. Melville: Was that on the record, your Honor?

The Court: Yes. I am serious about that. If there is something in the book your particularly want in evidence, perhaps we may get it in some way besides having it read into the record.

Mr. Melville: Well, I have in mind, your Honor, what this particular witness said in his book on pages 165 and 172 with respect to fair market value.

The Court: Well, I think the book has now been [229] identified. I think you may yourself read in whatever you wish.

Mr. Melville: Thank you, your Honor.

The Court: I would like to have you make it brief because I don't see any point in having a lot of it in here.

By Mr. Melville:

Q. You may follow me to make sure I quote you correctly.

"Fair market value is exclusively——"

(Testimony of Paul Paine.)

Mr. Mackay: Pardon me. Will you give me the page?

Mr. Melville: 165.

The Witness: Do you want this (indicating)?

Mr. Mackay: No, you keep it.

The Witness: I have a copy here. I knew he would drag it out.

Mr. Melville: Page 165, Mr. Mackay.

Mr. Mackay: That you, Colonel.

By Mr. Melville:

Q. "Fair market value is exclusively a legal term; its origin is in the law and there is its field. It is a synthetic expression and traditionally has come to mean that amount which would be paid at a specific time by a buyer, able and willing to buy, and accepted by a seller, willing but not forced to sell, with both buyer and seller having a reasonable knowledge [230] of the facts. The basis is, therefore, an assumption of a hypothetical trade or deal between an imaginary seller and an imaginary seller and an imaginary buyer. Unhappily the Courts in their usual endeavor to fit a single yardstick to many widely different conditions have failed to keep up with progress in the art of valuation by improving the legal technique or by clarifying the inconsistencies of decisions. Conflicts of decisions in the various jurisdictions are completely bewildering, and for this reason a valuation relating to fair market value must be predicated as to its nature and limitations upon a full definition from legal counsel."

(Testimony of Paul Paine.)

On page 167, the first full paragraph:

“Market price should not be confused with fair market value.”

Also, on the same page, “It is apparent, therefore, that the estimate of fair market value must rely upon a series of conceptions, all of which are hypothetical, as to what these fictional characters—the willing seller and the willing buyer—would do at a given time and place.”

Mr. Mackay: If your Honor please, I don’t want to interrupt the cross examination, but it is going to be awfully hard to follow this if he is going to read through a couple of hundred pages; a little bit here and a little bit [231] there, and examine on the whole thing.

The Court: He is apparently about through.

The Witness: I think this is good.

Mr. Melville: On this particular point I am, your Honor, on page 171, toward the end of that paragraph at the top:

“To a realist it is all very absurd; but it is the law, and it can be made intriguing and interesting if one brings himself and his reasoning processes playfully to array the buyer and the seller in a series of imaginative negotiations.”

And on page 172, the last paragraph before the references:

“Thus, fair market value is unique and is still undefined.”

(Testimony of Paul Paine.)

By Mr. Nelville:

Q. Now, Mr. Paine, passing——

A. May I answer your questions? I take it this reading takes the form of a question. I would like to answer it.

The Court: I take it now, so far, I think, he is about to ask you a question. Is that right, Mr. Melville?

Mr. Melville: I was about to leave fair market value, in view of what the Court has said. Perhaps I should ask a question.

The Court: If you have any questions, I will [232] permit you to ask him. If you do not and he cares to make any statement at this juncture, he will be permitted to do so.

By Mr. Melville:

Q. I have quoted you correctly, have I not, Mr. Paine?

A. Yes, except in this respect: That you have picked out selected sentences, without putting, embodying the context along that; and to that extend it has been quite misleading in places.

Q. Did I say anything you did not write or did not believe, or do not believe?

A. What you have erred in is by way of what you left out. You have unfairly quoted specific sentences, without giving the rest of the material. You know what I am talking about; except in that respect you have quoted this correctly.

Q. I don't want to be unfair about this, Mr. Paine.

(Testimony of Paul Paine.)

A. I don't think you do. I think you haven't understood how unfair you are.

Q. If I have left out anything you think ought to be added, you may do so, do so at this time.

A. It won't take me long.

The Court: You may proceed.

The Witness: The reference to a realist, it is all very absurd, refers very definitely to some material right ahead of it. You didn't read that, which would take the sting out of it as far as the legal fraternity is concerned. [233]

I don't want to go into this lengthily, but I do think in your first quotation, the quotations referring to page 165, you might well have added that the appraiser—it says here, “The appraiser must be patient and sympathetic. He must remember that, even if the hypothetical conception of the willing buyer and the willing seller is a fiction, it is one that has become established by legal usage and must be followed. The law seems to be fond of hypothetical situations and people; usually they are more tractable and responsive than their real counterparts, especially among the engineers. The shock we receive when we come to learn that we cannot reform our parents is slight compared with the shock to the engineer who attempts to reform court procedure.”

I am serious about this because I feel the engineer must be guided by the law and the work he does, and I endeavor to do that.

The Court: If the engineer had some yardstick

(Testimony of Paul Paine.)

that could be given to use to measure your fair market value in all these cases, we would be happy to receive it.

Mr. Mackay: Do you have any further comments on this?

The Witness: No.

By Mr. Melville:

Q. You also believe, Mr. Paine, don't you, that the work of the engineer has to be made to fit not only the law [234] but interests of his clients?

A. Yes. If his client—it must be interpreted properly. He mustn't necessarily adopt a partison attitude, if that is what you are implying.

Q. I think the book will speak for itself. On page 186 you deal first with fair market value, then present worth and come down to my employer, the Bureau of Internal Revenue.

The Internal Revenue Bureau receives many valuations in matters before this organization. A very complete documentary compilation is welcomed—one might say it is required. There are a few inhibitions as to length or elaborateness.

A. Unless it is shown no estimate based on comparable properties is possible. Engineering studies are in order if made for the purpose of arriving at the ratio of values with properties whose sales' history are none. In actual fact too often the question of values in gift and inheritance tax situations is resolved by parties and negotiations.

The Government reaches into the air and brings down a high figure. The estate of the deceased then

(Testimony of Paul Paine.)

hires experts who turn in a low figure. The two reports are incredibly apart, but finally a middle ground is reached and agreed to by both sides. Probably as reasonably correct an answer as could be reached in any other manner while done—have a correct conclusion obtained through an erroneous line of reasoning. [235]

Q. Do I understand, Mr. Paine, that you are an expert who has been hired by the petitioner in this case to turn in a low figure, to quote your book?

A. No, you don't understand that from anything I have said; and it is not true. That is silly.

Q. You wrote it.

A. Your question is silly, Not what I wrote.

Q. On page 4 under the subject of "Purpose," the first two sentences of that:

"Any concept of the value of a thing and the processes for ascertaining that value are bound to be influenced by the particular purpose for which the appraisal is being carried out. A valuation is never an end in itself, but may be required for any one of many purposes."

In your direct examination, Mr. Paine, you stated you have had experience in making valuations for security loans, for oil companies, with a view to sale, purchase, mergers, and so forth, and also valuations for the Securities and Exchange Commission, the landowner, that is, the lessor, and so forth.

Do I understand correctly from your book that

(Testimony of Paul Paine.)

in making these valuations for these various purposes you use a different method and arrive at a different result?

A. Yes. Frequently valuations made for a loan purpose [236] is directed directly to the question of the capacity of the property to pay the loan. The final ultimate value of the property is not ascertained with any degree of great care.

In other instances, a buyer of an oil property may be a refinery company which seeks a supply of oil. And he says, "I want that oil and I am ready to pay a good full price for it." That is a different purpose. Another purpose may be the ascertaining of market value.

Q. But if in each case you were asked to ascertain the fair market value as of a given date, for various purposes, would you have different answers?

A. Well, let me point out to you, in moving over from this quotation to this question which you now put, you introduce fair market value. If you go back to this excerpt you took out in that connection, I would call your attention to the fact that there is much more material on this subject on page 135 and page 150.

Why, I point out to you that on page 4 it says, "Any concept of the value of a thing—" not the market value. But then here we are talking about the value of a thing. Now, do you wish to introduce the expression "market value" in there or not? If so, then don't rely on the book.

(Testimony of Paul Paine.)

Q. Is it true, Mr. Paine, that the value of a property to a seller differs from its value to a buyer?

A. It may differ quite widely, depending upon the [237] circumstances. I can't answer that specifically unless you describe the seller and the buyer to me. I think it would help you if you read the last paragraph on page 150 on this subject.

Mr. Mackay: You have a right to explain that, Mr. Witness.

The Witness: I say, "Here again is the significance of the purpose for which a valuation is made and an indication of how the one property may be found simultaneously to have different values for different purposes," and so on.

"An engineering appraisal, computed in accordance with the wish of some one whose desire is the immediate investment of surplus income through the agency of drilling oil wells and whose tax position makes that course especially advantageous, may arrive at a value quite different from what is estimated for a company situated so that it is not prepared to advance development expenses and is, in fact, more concerned with early earnings and dividends in its operating and financial program. The meanings of the expression 'value' are very different to these two interests."

I think that is what you are reaching for.

By Mr. Melville:

Q. Mr. Paine, is there any legal complications

(Testimony of Paul Paine.)

involved [238] in making appraisals for the Securities and Exchange Commission, which you don't run into in making appraisals for ordinary clients?

A. Yes.

Q. Explain that, please.

A. The principal thing is that the Securities and Exchange Commission uses the word, not revelation, but something like that—you must reveal all the facts. You must hang all the wash out on the line and reports must be made for the Securities and Exchange Commission, which should be very full and complete in that respect.

But aside from that, the Securities and Exchange Commission gives one a great freedom in preparing it, the material.

Q. Is there any penal provisions in the event that you render an erroneous or false report?

Mr. Mackay: If your Honor please——

The Court: I wonder if we are not going afield. I have permitted you to go much further with excerpts both from the standpoint of the petitioner and the witness, and from the standpoint of the counsel for the Government, than is material to this case, of the reading from this book.

Yet I think it will soon begin to hold you down to general rules of cross-examination. I am not sure in going into the Securities and Exchange Commission, that it has much [239] to do with it.

We are dealing here with fair market value upon a basic date. The witness apparently understands what is meant by fair market value, from the law

(Testimony of Paul Paine.)

standpoint, and has attempted to give us his idea of fair market value. I would like to have your cross-examination limited, as nearly as you can, to testimony which the witness has given. Yet I don't wish to foreclose you from any proper cross-examination.

By Mr. Melville:

Q. Mr. Paine, at one point in your testimony you referred to using the price of 40 cents per barrel in making your estimates. Would you explain that, please, how you arrived at that 40 cents a barrel? [240]

A. Well, I compared it with transactions which I have observed from time to time that were actually made and their equivalent per barrel as those transactions were made; particularly this one of the Dominguez Oil Fields Company, in which the price at which that stock went out was equivalent to 31 cents per barrel in the ground.

This royalty was worth more money in the ground than the Dominguez Oil Fields Company's interest because the Dominguez Oil Field has to pay as a lessee the operating expenses, whereas the royalty comes to the Dominguez Estate Company almost clear of any contribution toward the development or the operations.

Other trades have been made in which the price—the equivalent value per barrel in the ground would range from 70 cents or more clear down to 15 cents. This 40 is my idea of what was a proper price for this.

(Testimony of Paul Paine.)

Q. In other words, it is your understanding that the parties have not agreed upon the probable future price of oil in this case?

A. I know nothing about that. I am considering just what would have been the view of the seller and the buyer at that date.

Q. And you took your own figure of 40 cents a barrel, rather than any figure that the parties may have agreed to? A. Oh, yes. [241]

Q. If the record should show that the parties had agreed to use specific prices for the future oil to be produced, with respect to various leases, would that change your testimony?

A. Wait a minute.

Mr. Mackay: Just a moment. I object to that, if your Honor please. The record is quite clear on that. We have stipulated, if your Honor please, the oil reserves, we have stipulated the probable future production.

The Court: I think his 40 cents a barrel that he is talking about it an entirely different item than the \$1.15 a barrel, or whatever it was, you stipulated in the probable selling price.

Mr. Melville: That is what I want to clear up. I am not clear yet.

The Witness: My 40 cents is my estimate, what the buyer and seller considered that oil to be worth in the ground, if your stipulation was the equivalent of an expected return of \$1.13 per barrel over the life of the property.

(Testimony of Paul Paine.)

By Mr. Melville:

Q. A barrel of oil is worth more to the lessor than it is to the lessee; is it not?

A. Generally it is worth more to the lessee than it is to the lessor because the lessee uses it in his pipeline and refining and marketing operations.

Q. Who bears the cost of lifting it?

A. The lessee.

Q. What does that cost of lifting usually run to per barrel?

A. It will vary from a few cents up to a large amount.

Q. How much?

A. Let me say—referring to your question which was what a barrel of oil was worth in the ground. Did you mean in the ground?

A. No, I meant at the surface.

A. No, it is worth more to the lessee than it is to the lessor.

Q. How about it in the ground?

A. Then it is worth more to the lessor than the lessee because the lessee must pay the cost of lifting, and the cost of lifting averages on this property—I wouldn't know precisely, but I would say it would be somewhere around 15 or 18 cents per barrel, or something of that order of magnitude, not including federal and state income taxes.

Q. Do you have any opinion as to what it costs to develop a barrel of oil, that is, discover the oil in the ground? A. Yes.

Q. About how much would you say here in Southern California? [243]

(Testimony of Paul Paine.)

A. It would have to be a wild guess, but I would say probably it costs 25, 30 cents. Now, I am answering your question which was to discover a barrel of oil in the ground. That does not include the cost of acquisition, development production.

Q. Now, frankly, Mr. Paine, I am referring to the report which you also referred to in your book, made by the Chase National Bank of New York City, as to the sources, disposition, characteristics of the capital employed by 30 oil companies.

A. Where is the reference in my book to that? Look at your date on that; a couple of years after my book.

Q. I stand corrected. This particular one was subsequent to your book.

A. Joe Poke didn't write that until a long time after.

Q. Didn't they write other analyses of this general subject? A. I think so.

Q. I just wanted to tell you what I had in mind, so it might help you answer my questions.

Now, you have answered the question as to discovery but qualified it by saying it didn't include other things.

A. No, I haven't qualified it. I pointed out to you, I answered your question about what it cost to discover the oil; that is, the exploration. [244]

Q. That is how much?

A. My estimate of 25 cents is just a wild guess. I rebel at being called to express it, it can vary so widely.

(Testimony of Paul Paine.)

We have that question of whether it is cheaper to buy oil that somebody else has found, or go out with a lot of geologists and expense accounts and try to find it yourself. No two companies have the same experience. Some companies—I don't want to make a speech.

Mr. Mackay: You have a right to explain.

The Witness: Some companies are characterized by having a large number of geologists, and they find it cheaply, but they buy it advantageously. A question of this kind is almost impossible to run down and get a figure on because the companies will not reveal them; others buy it advantageously.

By Mr. Melville:

Q. In making your valuation in this case, Mr. Paine, did you do so on the basis of value per barrel of daily oil production?

A. That was one of the courses I followed.

Q. Is that one you recognize as being——

A. Oh, yes. It isn't a primary one. It is one we use largely for checking others and for checking the merits of other properties. But it is one that is used professionally constantly by dealers.

Q. Would you explain—I am referring now to page 155 [245] of your book, the middle of the page, wherein you say:

“The method and the measure——”

This is on the subject, incidentally, of the daily barrel——

“——lack precision and have no direct field in finished valuation practice.”

(Testimony of Paul Paine.)

Would you explain that, in the light of your previous answer?

A. By finished valuation I mean these engineering and analytical appraisals, which work out each on the right-hand side of the decimal point. Is that clear?

Q. Not exactly. Did you make a finished analytical appraisal in this case? A. Yes.

Q. So that this, in your opinion, this method has no direct field or has no application, as I understand it, then, to a finished analytical appraisal.

A. You are mixing up apples and cranberries, Mister. You can't use this method in an analytical appraisal. Understand analytical or engineering appraisal is one derived of an estimate of the present worth of the future profits.

Mr. Mackay: An appraisal by this method is a different method of appraisal. You are not going to use one for the purpose of accomplishing the other, which I understand your question to be. [246]

By Mr. Melville:

Q. What method did you use in this case then?

A. In my appraisal of the market value?

Q. Yes.

A. I used the method of making all these appraisals, wrapping them up and looking them over and weighing them and arriving at my estimate. Market value must be an estimate. It can't be a precise meticulous mathematically derived figure. It has to be an estimate. It is based on the conception of a transaction which did not take place be-

(Testimony of Paul Paine.)

tween two persons who do not exist.

Q. Is the pay-out method a recognized means of valuation? A. Yes.

Q. Do you use that in this case?

A. Yes, I testified that.

Q. What value did you get on the pay-out? How many years pay-out did you use?

A. Four years and five years. The value at five years was \$3,134,620.00. And at four years was \$2,504,896.00.

Q. You are generally familiar with the oil properties that we are appraising here?

A. I think I am, yes, except some of these isolated small properties.

Q. The Reyes lease?

A. The Reyes and the Carson-Union. [247]

Q. Mighty good lease; isn't it?

A. Splendid property and well operated.

Q. Do you know of any properties in Southern California that are any better? A. Yes.

Q. Would you classify it as one of the best?

A. It is a very good property; no question about that.

Q. One of the best?

A. I would almost go that far with you, yes. It isn't one of the best. It wasn't one of the best on this date because those Miocene wells were beginning to show very high gas and oil rate. At this date it was wondered how far that Miocene sand was going to go.

(Testimony of Paul Paine.)

Q. Would you say the Reyes lease was settled production?

A. I am sorry. I will have to ask you to define the "settled production." The reason for that is that settled production is used very sloppy, especially by attorneys. I will endeavor to answer your question if you will tell me what settled production is. I don't know. I am not trying to avoid your question. You tell me what you mean by settled production.

Q. I was just quoting from your book, so I will read the part that I had reference to. Page 151, under "Payout Method," the second paragraph there ends with this sentence: [248]

"The payout period in transactions of developed oil properties has generally ranged for working interests from four to seven times the annual earnings. Many dealings in royalty interests under wells which are settled and severely curtailed have been transacted for as much as twelve times the annual rate of return."

Now, Mr. Paine, in view of that statement in your book, wherein you state that from four to seven times and in some cases as much as 12 times, why do you use such a low period in valuing the oil royalties in this case?

A. First let me refer you to page 41 which says:

"Settled production is an expression which has many interpretations. It is applied to the

(Testimony of Paul Paine.)

yield of a well or of a property. To the layman it can be seriously misleading if he accepts it to mean a productivity rate which has ceased to change or a decline that has come to rest."

It goes on. It will tell you about what settled production means.

Now, the 12 times the annual rate of return referred specifically to those properties which are very severely curtailed; the West Texas Oil Field properties which had [249] tremendous capacity to produce and yet were having their oil withdrawn at very low rates.

Now, the lower rates would all be a function of how one views it and how one feels about its trading range.

No small element in all of these situations is the income tax outlook and the occasion, the feeling of one that the return is not going to be as great as he might infer from a study of the figures without some consideration of his tax position.

Q. That concludes your answer?

A. Yes, sir.

Q. What I am trying to get at, Mr. Paine, is this: You have testified that the value of oil in the ground is greater to the lessor than to the lessee. Is that correct?

A. A barrel of oil in the ground generally is.

Q. And your book says that from four to seven years pay-out for the lessee; doesn't it?

(Testimony of Paul Paine.)

A. Yes, in some instances. I don't think it lays it down as a fixed rule.

Q. That is a broad range, four to seven?

A. Not in the oil business, no.

Q. Then you go up to 12, which you explain what fields the 12 would apply to. Would the 12 apply to the Reyes lease? A. No. [250]

Q. If four to seven is the proper years to apply to the lessee, what would be the years to apply for the lessor interests.

A. It all depends on the circumstances. Describe the property to me.

Q. Reyes.

A. There wouldn't be much difference there because it isn't severely curtailed. As a matter of fact, a lot of that oil in the Reyes lease is more valuable to the lessee than it is to the lessor, because they take oil right over to their refinery, run it through, market it, distribute it.

Q. Didn't your testimony earlier this afternoon establish that in your opinion oil in the ground was of more value to the lessor than to the lessee?

A. I think that generally is the case.

Q. Isn't that true in the Reyes lease?

A. I don't know, because I don't know what the value of that—let me finish my answer. Relax. I don't know what the value of that oil is to the Shell Company or to the Union Oil Company, as far as its ultimate worth and what they are able to do with it. Whereas, the landowner gets his cash settlement from the company.

(Testimony of Paul Paine.)

Q. Well, it is certainly worth as much to the lessor as it is to the lessee; isn't it?

A. Is this in the ground or at the surface? [251]

Q. In the ground. That is where the oil still is we are valuing here.

A. Yes. It would be the difference—the difference would be academic. I can't be responsive more thoroughly to it than that.

Q. Tell us, Mr. Paine, since in your book you said four to seven years was proper for the lessee and since you now state that the lessor's interest was just as valuable, why do you use the minimum of four rather than the maximum of seven, in view of your testimony that the Reyes lease was one of the best?

A. I don't know why, as far as the book is concerned. I can't answer for how I was feeling about it at the time of the book. Let's leave it there. I don't certify to you that every statement in the book is correct. The book, in some places in the book I speak about royalty oil or oil in the ground being worth nearly always 50 cents a barrel. As a matter of fact, there have been widespread deviations from that. In instances in 1934 oil in the ground in Santa Maria was selling to the basis of about 14 cents a barrel in the ground.

Q. We are talking about 1941, Mr. Paine, the year in which you wrote this book. This is what you say on page 110:

“The cost of finding and buying lessee oil

(Testimony of Paul Paine.)

of good quality in the [252] ground which has been discovered by another person is greater than 40 cents."

You haven't changed your mind about that?

A. I don't say that is an inflexible rule that follows in every instance. As I say, I know of instances where oil has sold in the ground for 14 cents or 15 cents.

Q. Well, let me just read one more paragraph from this same subject matter on page 111:

"Oil in the ground which is proved up but not drilled up is, therefore, a unit of commerce. As such, it engages the attention of the appraiser and is found to sell for as much as 50 cents or more per barrel, depending on quality, crude prices, costs, and other factors. Almost any crude for which there is a market and which can be profitably obtained is fairly worth 10 cents per barrel in the ground."

Do you have an opinion at this time as to how much the oil in the Reyes lease was worth in the ground in 1941?

A. To the lessor?

Q. Yes. A. 40 cents a barrel.

Q. Is that the figure on which you base your appraisal? [253]

A. Yes.

Q. You consider oil royalty as a good investment?

A. Good oil royalties are a very good investment.

(Testimony of Paul Paine.)

Q. We are talking about good oil royalties in this case.

A. You are doing the talking. These are very good oil royalties; it is a splendid investment.

Q. You think this is a splendid investment?

A. Yes.

Q. You consider it a good hedge against inflation?

A. I haven't been much of a believer in inflation and I haven't leaned toward getting much of a hedge. There is probably a hedge, but investors think so more than I do.

Q. You said something in your direct examination about the factors you took into consideration in valuing the stock of the Dominguez Estate Company. Did I understand you to say that one of the factors or one of the reasons why you applied a certain discount was the cost of making a market for it?

A. The cost, the difference that is reflected in getting the stock out into the investment channels, going through the financial houses and generally that is not less than 10 per cent.

Q. Now, Mr. Paine, if a given stock, let's say Chesapeake & Ohio, today sells over the New York Stock [254] Exchange at \$58.00 a share, does that, in your opinion, establish the fair market value?

A. If it is being traded in at \$58.00 a share I would think that is the fair market value.

Q. Supposing there was 1,000 shares sold today, at one figure and one figure only, \$58.00 a share,

(Testimony of Paul Paine.)

would that, in your opinion, establish that \$58.00 is the fair market value of Chesapeake & Ohio?

A. That would be my opinion, yes.

Q. How about the broker's commission that would have to be paid by the seller and the buyer?

A. Each one of those goes, each on one side of that \$58.00.

Q. That is my point. Therefore, why did you take the discount to cover the making of a market?

A. Because this stock is unknown. It has no market. It wasn't listed. It wasn't traded. You are comparing a stock that was established on the trade that was listed, that was being dealt in. Now, you don't move a stock that is in a hermit company. That is unknown. That has no market. You don't move that out into the listing and the stock exchanges without some expense.

Q. Would it surprise you to know there was a ready market for this stock?

A. Yes,—not that there is a ready market for this [255] stock, but you would have to name the price for me. There is a ready market for any stock. There is always somebody up on the third floor of these buildings that will buy these stocks, but you have to put the price right.

Mr. Melville: No more questions.

Mr. Mackay: That is all, Mr. Paine.

(Witness excused.)

The Court: We will suspend for a brief recess.

(Short recess taken.)

Mr. Mackay: I will call Mr. Lovelace.

JONATHAN B. LOVELACE,

called as a witness for and on behalf of the petitioner, having been first duly sworn, was examined and testified as follows:

Direct Examination

The Clerk: Will you give your full name for the record?

The Witness: Jonathan B. Lovelace.

By Mr. Mackay:

Q. What is your address, Mr. Lovelace?

A. 650 South Spring Street, Los Angeles.

Q. What is your business?

A. Investment research and investment management.

Q. Mr. Lovelace, will you start with your education [256] and briefly sketch your career up to the present date?

A. I was graduated in 1913 from the Alabama Polytechnic Institute, with a degree of bachelor of science and engineering. I took the Master's Degree the following year and remained there as instructor through the summer of 1917.

In 1917 I entered the Officers' Training Camp and on graduation was commissioned second lieutenant and volunteered for service in France.

I went to France in December, 1917, and served throughout the war in the anti-aircraft artillery, ending up as a captain at the end of that service.

(Testimony of Jonathan B. Lovelace.)

Early in 1919 I returned to the United States and I entered the employ of E. E. MacCrone & Company, Detroit, Michigan, who were members of the New York Stock Exchange. I remained with that firm until the fall of 1929. My work at the outset was as statistician and analyst, and subsequently I became head of the underwriting department and in charge of the company's investments.

I became a partner in 1924, and as a partner had a voice in passing upon underwritings, negotiations of underwritings, and the management of investment funds of the firm and of an investment trust which represented funds of a number of small investors consolidated into one investment trust, which the firm sponsored.

In the summer of 1929 we had a disagreement between [257] the partners as to our policy with respect to our common stock holdings. I favored the sale of stocks and when my views were not followed I determined to withdraw from the firm in order to cash in on the values which then obtained. I gave notice of withdrawal in September, 1929, and the following year I move to California.

In 1931 I was asked by a group of businessmen in Los Angeles, who were then the directors of two local investment companies, namely, American Capital Corporation and the Pacific Investing Corporation, to organize a research group to analyze and recommend investments for the portfolios of those two companies.

I formed such a company under the name of

(Testimony of Jonathan B. Lovelace.)

Capital Research Company, and subsequently I became chairman of the investment committees of the law investment trusts referred to.

In August, 1932, I was made chairman of the investment committees, with primary responsibility for the management of the funds of the two companies, the Pacific Investing Corporation having become Pacific Southern Investors, Inc., through merger in early 1932 with Southern Bond & Share Corporation.

Since August, 1932, I have continued to direct the work of the Capital Research Company and to supervise the buying and selling of securities for these two investment [258] companies in my capacity as chairman of the investment committees, with primary responsibility for portfolio management.

Late in 1932 I was requested to assume the presidency of the Investment Company of America, a common law trust which was under the management of a trustee corporation directed by members of the firm of E. E. MacCrone & Company, from which I had retired in September, 1929. I assumed the presidency of the trust and also the presidency of the management corporation which supervised the portfolio of the trust.

The Investment Company of America was converted into a corporation in December, 1933, and I have since continued as president of the Investment Company under a management contract. I have since continued as president of the Invest-

(Testimony of Jonathan B. Lovelace.)

ment Company of America and as president of the company which manages the funds of that company under a management contract.

My present activities are those of president of the Capital Research Company and of Capital Research and Management Company, chairman of the Investment Committee of Pacific-American Investors, Inc., and president of the Investment Company of America.

In addition to my work in this investment field, I am now, and have been for several years, a director of the [259] following corporations: Pacific Indemnity Company, Pacific Finance Corporation, Automobile Finance Company, Barker Bros., leading house furnishings company. In addition I am a trustee and a member of the executive committee of the Southwest Museum, and a member of the finance committee of the Huntington Memorial Hospital, institutions having endowment funds administered by their respective trustees.

Q. Now, going back to your experience in Detroit, you mentioned underwriting. Will you please tell us what was the nature of your underwriting experience? Name some of the companies that you handled.

A. I made the analysis to determine the public offering price and the underwriting price of the common stocks of several corporations. Those coming first to mind being the Seagrave Corporation, which is engaged in the manufacture of fire-fighting apparatus; the Holland Furnace Com-

(Testimony of Jonathan B. Lovelace.)

pany, which manufactures warm air furnaces and heating equipment; and Mead Johnson Corporation, which manufactures food products for infants and children.

Shares of these companies were successfully marketed, the first two being traded in now on the New York Stock Exchange and the latter on the New York curb market. These are the companies in which I had the primary responsibility for the analyss of the company and the negotiations for underwriting, but I participated as a member [260] of the firm in decisions in respect to a number of other companies whose common stocks subsequently were and now are being traded on the principal exchanges of the country.

Q. Now, in connection with your work with that firm in Detroit, did you have charge of any investment funds, purchases and sales of stock? I think you have already testified regarding one investment trust.

A. Aside from the company's own holdings, the principal fund which we managed was that of the Investment Company of America, the investment trust which I referred to above. The firm had a number of individual clients of considerable wealth with whom we advised as to the purchase and sale of common stocks, but this work was more of an investment counsel nature, rather than a direct management.

Did you personally have charge of that work in the firm?

A. Yes, I was manager of the investment re-

(Testimony of Jonathan B. Lovelace.)

search and management department and responsible to the partnership for that branch of the work.

Q. Now, in connection with that work, what was your method of approach and the type of activity carried on?

A. The object of our research and management department was to keep the funds of the investors at work in common stocks which were considered to have the greatest promise with respect to dividends and appreciation. [261]

In developing the background for this work, we organized a staff of economists, statisticians and analysts.

We first made an analysis of the general economic situation, taking into account the political situation, economic conditions and all factors which have a bearing on the future of securities prices. This was for the purpose of determining whether or not conditions were favorable for the purchase or retention of common stocks. Then we analyzed the industries to determine which industries were most favored by prevailing economic conditions. Then we analyzed the individual companies for the purpose of determining which companies within the industries appeared to have the greatest potentialities.

This work involves study of capital structures, appraisal of managements, and so forth. From the reports of this staff, we would determine the individual stocks which should be purchased, those

(Testimony of Jonathan B. Lovelace.)

which should be retained, and those which should be sold.

Q. Now, you have testified in 1931 you became connected with the American Capital Corporation and what is now the Pacific Southern Investors, Inc., and I think you also testified that in August, 1932, you became chairman of the investment committee of each of these companies? A. Yes.

Q. State briefly the nature of your duties and activities in connection with those companies.

A. As chairman of the investment committee of the two companies referred to I was given primary responsibility for the management of their portfolios, and, as background for that work, I had before me the studies of the Capital Research Company, which had been formed for the purpose of supplying the material needed as a background for the determination of investment policy and the selection of individual issues. The Capital Research Company was staffed in much the same manner as that I described for the research organization when I was in Detroit. We retained Dr. Lionel D. Edie as consulting economist, and I secured the services of a number of analysts and statisticians who were carrying on the work of analyzing industries and companies.

The research reports were made available to the investment committee, and in my capacity as chairman, I had authority from the board of directors to determine upon investment policy and to place orders for the purchase and/or sale of securities

(Testimony of Jonathan B. Lovelace.)

held by the two investment companies. Since I was president of the Research Company, as well as chairman of the investment committee, I was continuously working with the research material, and from my studies I made recommendations to them with respect to securities offered and those contemplated for purchase, and these recommendations were usually followed. [263]

Q. I think you also mentioned The Investment Company of America, to which I think you returned late in 1932. A. Yes.

Q. What has been your duties with the corporation or trust since 1932?

A. I had been president of The Investment Company of America over that period. In addition, the president of the Management Corporation. My duties as president of the management company were essentially the same as those of chairman of the investment committees of the two local trusts. I had the major responsibility for supervision of the investment portfolio of The Investment Company of America.

Q. Am I correct in understanding that since 1932 you have had the principal responsibility for the purchase and sale of assets owned by these three investment trusts or companies that you have mentioned? A. Yes.

Q. What are the relative sizes of these companies?

A. Pacific Southern Investors, Inc. and American Capital Corporation were merged in 1943, in

(Testimony of Jonathan B. Lovelace.)

August to a company known as Pacific-American Investors, Inc. The assets of that company at June 30, 1945, were approximately \$15,350,000.00. The assets of the Investment Company of America were approximately \$5,250,000.00.

Q. You say you have had primary responsibility for the [264] management of these three companies since August, 1932. Can you tell us what the operating results have been and something about the method of operation?

A. In the case of Pacific-Southern Investors, Inc. and American Capital Corporation the audited report of Messrs. Haskins & Sells was made to trace the record of the earnings and gains for stockholders of the two companies from August 31, 1932, to December 31, 1942. That showed a total of net income and gain for securityholders of 93.36 per cent for Pacific-Southern Investors, Inc. and 98.71 per cent for American Capital Corporation; an average of 97.53 per cent which is at the rate of 9.4 per cent per annum over this period.

The net assets of the merged company as of December 31, 1942, giving effect to the merger, were \$10,024,000.00 and the net assets of the company as of June 30, 1945, were \$15,372,000.00, an increase for the two and one-half year period of more than 50 per cent, or, in dollars, in excess of \$5,000,000.00; and this gain is after dividend payments for the period exceeding \$1,000,000.00. So that over the 13-year period the annual return has been something like 11 per cent per annum average.

(Testimony of Jonathan B. Lovelace.)

In the case of The Investment Company of America, which is an open end investment trust, the results are published periodically in Barron's Weekly where comparison [265] is made with the results achieved for other like funds.

In its issue of January 29, 1945, Barron's published a table showing the results achieved for shareholders of all of the leading open-end investment companies over a period of years, and inserted a column showing results for the war years, that is, in the period from December 31, 1938, to December 31, 1944, inclusive. In that period they showed the gains for shareholders of The Investment Company of America amounted to 55.9 per cent, the highest of any company, and comparing with an average of 35.6 per cent for all of the companies tabulated.

Q. What are the average number of issues held by each of these companies and what volume of sales or purchases are made on the average for each of these companies during the calendar year?

A. We try to hold between 70 and 90 individual securities to get wide diversification. During the course of a year we may sell as many as 25 or 30 of these issues and we may buy a like number and put the amount of money into a lesser number of securities we feel complete confidence in.

Q. In connection with each of these sales or purchases, what is your method of investigation by way of determining the new issues which you are going to purchase?

(Testimony of Jonathan B. Lovelace.)

A. The staff of analysts is continually studying the outlook for various industries. When we can detect a [266] change for the better in an industry not represented in our portfolio, we then seek to find the strongest company in that industry, the company with the soundest capital structure, the ablest management and most favorably situated, the company having the greatest potentialities in that particular industry. We not only have statistical analysts but men in the field calling on corporations and trying to find out what new products they have and what their plans are for the future. Under certain conditions we might conclude that the public utility industry was faced with such difficulties that we would not care to own any securities in that industry, and buy into some other industry, automobiles or broadcasting that we thought had better prospects over the years ahead.

We are constantly weighing the outlook for various industries and weighing the situation of individual companies, seeing what price the company is selling at in relation to its earning power and its prospects for future earnings.

Q. Mr. Lovelace, have you made an appraisal and formed an opinion as to the fair market value on June 5, 1941, of the Dominguez Estate Company stock?

A. I have.

Q. In doing that are you familiar with the stipulations that have been filed in court, and the exhibits?

A. Yes. [267]

(Testimony of Jonathan B. Lovelace.)

Q. You were given copies of them?

A. I was, yes.

Q. You have made an analysis of it?

A. Yes.

Q. Now, would you please tell the Court what the general market conditions were at June 5, 1941, here in Los Angeles?

A. Yes. In order to refresh my mind as to conditions in June, 1941, I read back through the commercial and financial columns and Moody's Investor Service, to see what they were saying at that time, as a check on my memory.

We had some pretty hectic years. We don't try to remember precisely the conditions at a date like that. I took the Moody's Service which comes out each week and read through their comments, summaries of their comments for May 5, 1941, through to June 9. That is the period just ahead of the date of this appraisal. The issue of May 5th says:

"Sagging prices without any heavy liquidation were seen in last week's stock market. Many stocks touched new lows for 1941 and some fell below their lowest levels of the previous year. No startling news accompanied this market reaction which seemed due to the obvious——"

The Court: I suggest we not read from the reports. You tell us the general conditions of the market. I think it would be better.

The Witness: The condition of the market at the time was one of fear. It was a period in which

(Testimony of Jonathan B. Lovelace.)

developments [268] in Europe were very unfavorable. There was great concern about higher taxes. There was concern as to whether we would get into the war or not, and particularly since May 29th, I believe it was, 1941, the President declared an emergency. I am not sure of the exact title he used. He declared unlimited emergency May, 1941.

The attitude of investors generally was one of uncertainty, and particularly of fear regarding higher taxes, because that was—new tax proposals had been made in May, 1941, all looking toward higher taxes. The Treasury had set the goals of increasing its income from \$12,000,000,000.00 to \$19,000,000,000.00. That forecast was surely higher taxes. Under those circumstances the investors were rather cautious, and as a result you had common stocks selling very low in relation to their assets and earnings.

By Mr. Mackay:

Q. Well now, you stated the common stocks were selling low with respect to their relationship of their assets to their earnings. Can you give us some light on that, as to what stocks you have in mind?

A. Yes. I went through a list of stocks we follow as being interesting companies with interesting prospects, and I listed 50 companies. I might give a few. American Radiator Company, Atlantic Refining, Bethlehem Steel, Borg Warner, Byron Jackson, Chesapeake & Ohio, Chrysler [269] Corporation, Columbia Broadcasting, Commercial Credit,

(Testimony of Jonathan B. Lovelace.)

Commercial Investment Trust, Consolidated Edison, Deere & Company, Douglas Aircraft, Dresser Manufacturing, Electric Auto-Lite, Food Machinery, General Motors, Goodrich, Goodyear Tire & Rubber, Greyhound, Holland Furnace, Kalamazoo Stove, Lambert Chemical, Libby-Owens-Gord—

The Court: Do you want all of these in? I think we have enough.

The Witness: A representative list of stocks. Those stocks were selling June 5, 1941, to yield on the average of 9.6 per cent and were selling at 7.1 per cent times the 1940 earnings, and 8.2 per cent times the 1936 to 1940 average earnings.

Take the same list and eliminate the aircraft and oils and steels as being special situations there, particularly in the steels and aircraft for the very high earnings, because of the war situation, and the average earnings ratio dropped to 7.8 per cent, instead of 8.2 per cent for the 50 stocks; but not any material difference.

Roughly, the common stock of very important companies, all listed on the New York Stock Exchange, were selling at about eight times the net earnings of the preceding five years, and about seven times the earnings of 1940.

Q. Did you make a comparison as to the relationship of the sales price of those stocks to their market value of [270] the assets behind them?

A. I didn't. I did to the oil companies. They were more pertinent to these analyses. They were

(Testimony of Jonathan B. Lovelace.)

selling generally about 45 to 50 per cent of the asset value.

Q. What do you have to say about that? That is, the oil companies? A. Yes.

Q. When you speak of the oil companies, those were the oil companies whose stocks were listed on the various exchanges?

A. I didn't get the question.

Q. When you speak of the oil companies, those were the oil companies whose stocks were listed on the various exchanges?

A. Yes, listed and actively traded on the New York Curb, and New York Stock Exchange, and so forth. In fact, I have several oils in this group, I thought it better as a measuring stick to take the average of a broad list of stocks. Any investor considering the purchase of the Dominguez Estate stock or any other stock would compare it with any other stocks available in the market.

Q. What oil stocks did you take under consideration?

A. I haven't my list here. I notice I didn't place a great deal of weight on that. I took another approach in my appraisal. I can furnish it if you would like to have [271] it.

Q. Now, Mr. Lovelace, taking into consideration the stipulation and the exhibits that have been offered here, and your knowledge of the market conditions at that particular time, will you please tell the court how you arrived—and assuming that the oil royalty of the Dominguez Estate Company

(Testimony of Jonathan B. Lovelace.)

at June 5, 1941, had a fair market value of \$3,000,000.00, will you please tell the court how you arrived at your valuation and what it is?

A. I placed a value on the stock, fair market value on the stock of Dominguez Estate Company as of June 5, 1941, of \$418.00 a share.

Any security, the value of a security, the fair market value is dependent on earning power and on its assets, the ability to earn money over a period of years, the dividends it can pay and the marketability of the investment.

In the case of Dominguez Estate Company, taking the assets at the stipulated figures, and taking the oil property at \$3,000,000.00, a total net asset aggregates \$7,979,699.00. That is a net asset value per share on the 10,499 shares of stock; net as set per share of \$760.04.

The first approach was what you might call an asset approach, as to what would be the value of the stock of a corporation which had a net asset value of \$760.04. In arriving at that you have available in the market certain [272] investment companies, the assets of which are all liquid, and are all computed quarterly and published to investors.

One, for example, is the Lehman Corporation. It has net assets of \$53,000,000.00. The asset value as of March 31, 1941, and as of June 30, 1941, were both published and made public. The difference between the asset value of those two dates was practically nil, practically no difference between

(Testimony of Jonathan B. Lovelace.)

the asset values of investment companies on March 31, 1941, and June 30, 1941.

The Lehman Corporation, for example, had a net asset value which is based on the market value of all the assets it owns. The same way the Dominguez Estate is based on the stipulated values or the fair market value of the individual items Lehman Corporation had an asset value of \$28.58 and was selling at \$20.58. That is a discount of 27.8 per cent.

The National Bond & Share Corporation, which is also listed on the New York Stock Exchange, had an asset value of \$21.07, and a market value of \$14.25, and a discount of 32.4 per cent.

The Consolidated Investment Trust of Boston, which is not listed but traded in Boston had net assets of \$11,900,000.00 and net asset value of \$37.05. Its market price was $22\frac{3}{4}$, a discount of 38.6 per cent.

The Security Company, a Los Angeles company, has total assets of \$5,700,000.00, listed on the Los Angeles [273] Stock Exchange. That company had a net asset value of \$48.30, and stock was selling at $29\frac{1}{2}$; 39 per cent discount.

Shawmut Association, on the Boston Stock Exchange, had net asset value of \$16.16 and was selling at $9\frac{3}{4}$, discount of 39.7 per cent.

Outside of the two stocks listed on the New York Stock Exchange, Lehman and National Bond & Share had an average discount of 30 per cent. We find the discounts in these other securities where the market was more limited approximately

(Testimony of Jonathan B. Lovelace.)

39 per cent, 38.7—38.6 in the case of Consolidated Investment Trust of Boston. 39 per cent in the case of Security Company of Los Angeles, and 39.7 per cent in the case of Shawmut Association. In other words, the less liquidity the shares of the investment company had the greater discount. Generally that is applied or required by investors to invest in that situation.

Taking that approach I felt that if any investor or potential investor were approached with the idea of buying Dominguez Estate Company and was told that this stock had an asset value of \$760.00 a share and he could buy it at a bargain, he would require discount of at least 45 per cent, because he would be buying into a non-liquid personal holding company situation; where he could get 40 per cent by buying into Security Company stock listed on the Los Angeles Stock Exchange. The securities that the Security Company [274] owned were all readily marketable and appraisable. They did have a small amount of real estate, I think about \$400,000.00 of real estate. Generally the assets were liquid and the shares of the company were moderately liquid, inasmuch as they were traded on the Los Angeles Stock Exchange.

I felt an investor would require, as I say, at least a discount of 45 per cent to be interested in the Dominguez Estate Company stock. And that applying the discount of 45 per cent to the net, as set value, we arrive at the figure of \$418.00 a share.

(Testimony of Jonathan B. Lovelace.)

The second approach is to take the earning power of a company and see how this would stack up relatively, on the basis of earning, relative to other companies. I have just said these 50 stocks listed on the New York Stock Exchange were selling at 7.1 times their 1940 earnings. If we apply that ratio to the adjusted earnings of Dominguez Estate we arrive at a valuation of \$215.63.

I might say that in this figure of adjusted earnings I have adjusted the earnings recorded for Dominguez Estate Company by adding back to the earnings the depletion the company charged off in arriving at those earnings, and applying the depletion of 27½ per cent which is the figure used by the government in allowance for depletion charges.

Q. When you say you added it back, you mean the cost depletion shown on the books? [275]

A. Yes. And then substracted the other to arrive at earnings. On that basis-----

Mr. Mackay: If your Honor please, I may state for the record that that exhibit does not show certain amounts of cost depletion on the books. I think that is 4(d).

The Witness: All right. The exhibit referred to there showed there was a depletion of cost of oil, less very nominal figures for recent years, but high figures for the early years because they followed the policy of amortizing on the cost, rather than using a uniform depletion charge.

Taking the figures as stipulated upon, as based on the books of the company, and adjusting for

(Testimony of Jonathan B. Lovelace.)

depletion, we found the earnings of Dominguez to be as follows:

For the year 1932, \$35.07 per share;

For the year 1933, \$30.84 per share.

The Court: Let me ask a question so I might follow you on your adjustment on the depletion. I am not sure I quite understand what you did. That is, for 1932 your depletion of cost is \$413,000.00, is that right? You have the exhibit. I don't wish to confuse you. I am trying to straighten myself out.

The Witness: Yes, that is right.

The Court: You take that out of the income——

The Witness: Add that back to the income.

The Court: Add that back to the income? [276]

The Witness: And then subtracted uniform depletion of 27½ per cent. Let's take the last year and it will be a little easier; take the year 1940.

The Court: All right.

The Witness: In the year 1940 the company showed approximately \$500,000.00—showed \$496,000.00 after the taxes.

Let me go back. The figure there shows the net income before book gain on the sale of real estate of \$488,498.00. You take that figure and add back the \$42,000.00 charged off for depletion and you have a figure of \$501,000.00-plus.

The actual oil royalty in that year was \$665,000.00 up in the income account. That should have been depleted 27½ per cent of uniform depletion charge.

(Testimony of Jonathan B. Lovelace.)

27½ per cent of the oil royalty received amounted to \$183,000.00. Subtracting \$183,000.00 from the figure \$501,000.00 we come out with \$318,018.00 as the adjusted net earnings for the year 1940. That is equivalent to \$30.37. a share.

The effect of this company reporting on a book basis was to overstate the earnings in the latter part of the year. They were making no charge for depletion since they didn't have the property on their books at any capitalizable value, although its value was being depleted. [277]

Mr. Mackay: I might state, for the record, I think it is a fact that this company's depletion got on the books because of certain reorganization back in 1928. And the Commission has not permitted the depletion to be based upon cost. While it is on the books it had to be written off. I think that is the reason why all of the witnesses have added it back, your Honor.

The Witness: The necessity for restating their earnings is clear when you note that in the year 1940 the charge for depletion was only \$42,000.00. Whereas, the company took in \$665,000.00 from its oil property, and at the end—as of June 5, 1941, oil property still had a value of \$3,000,000.00. If that \$3,000,000.00 was put on the books and the life was 14 years and had straight amortization you had to charge off 1/14th of \$3,000,000.00 over the 14 years, which was approximately \$200,000.00 a year.

The government has accepted a policy of deple-

(Testimony of Jonathan B. Lovelace.)

tion charge of 27½ per cent. We have applied that per cent in restating these earnings. So that I would like to say, because I refer to the average earnings and so forth, that restating the earnings, the figures we arrived at are as follows:

For 1932, \$35.7 per share;

1933, \$30.84.

The Court: Are you going through several years there? [278]

The Witness: I was going to give the 10-year period.

The Court: I wonder if that couldn't be put in a schedule and put in as a schedule.

Mr. Mackay: I think so.

The Court: Put it into the record here.

Mr. Mackay: It is quite all right with us.

Mr. Melville: It is my understanding, your Honor, the earnings are all stipulated.

The Court: He is showing how he has adjusted them, and he has explained how he adjusted them. I thought it might be easier if we had a schedule showing the 10 or 11 years' adjustments. We are about to suspend, anyway.

Mr. Mackay: Yes, your Honor. I can't finish this witness, anyway. I think it would be all right.

The Court: Well, possibly you may wish to have him bring such a schedule in so you can put it in as an exhibit. I am not telling you what to do. We will suspend at this time until 9:30.

(Whereupon, at 5:00 p.m., a recess was taken until 9:30 a.m., Wednesday, October 10, 1945.)

PROCEEDINGS

October 10, 1945—9:30 a.m.

The Court: You may proceed, gentlemen.

Mr. Mackay: Will you read the last question and answer?

(The record was read.)

JONATHAN B. LOVELACE
resumed his testimony as follows:

Direct Examination—Resumed

By Mr. Mackay:

Q. Have you that schedule?

A. Yes. I would like to make one correction.

Q. All right.

A. The figure referred to as the depletion charge in 1940 was not——

The Court: Well, you have a schedule now that was made out that is correct and complete straight through, do you?

The Witness: Yes, but it does not show that figure and I would like to make that correction.

The Court: Very well.

The Witness: In 1940 the correct depletion charge—the depletion actually charged was—as shown by the stipulation the figure was \$2,071.18, and this requires a correction in my earlier figures there.

(Testimony of Jonathan B. Lovelace.)

The net results are the same but the figure referred to previously as to the income after depletion [284] should have been \$499,838.80, and the depletion of \$2,071.18 made a total adjusted income of \$501,909.98, and after adjusting for depletion at 27½ per cent, the figure becomes \$318,807.75. The result of these adjustments was to decrease the indicated earnings for 1940 from \$47.61 to \$30.37, and that for the year 1942 to increase the earnings from \$11.41 to \$35.07. Because of the difference in depletion charges it increased the earnings at the end of the period and decreased them at the early part of the period because the company had made very high depletion charges in early years. For instance, in the year 1932 when the royalty income amounted to \$601,000.00, the depletion charge was \$413,000.00 according to the books, yet in 1940 when the oil royalty income was \$666,000.00, the depletion charge was only \$2,000.00. I made the adjustments to put them on an equal basis over the period and in order to make the comparison fair with listed stocks that I used as a measuring stick to check my valuations of the company.

By Mr. Mackay:

Q. Do you have a copy of the list you checked with?

A. (Producing) It was not re-typed.

The Court: Off the record.

(Discussion off the record.)

Mr. Mackay: If your Honor please, I should like to offer this in evidence. [285]

(Testimony of Jonathan B. Lovelace.)

The Court: This is the schedule that we talked about last night on the average earnings for the ten-year period?

The Witness: Yes. That is earnings by years for the period.

The Court: Very well. That may be marked Petitioner's Exhibit No. 25 and received in evidence.

(The schedule referred to was marked and received in evidence as Petitioner's Exhibit No. 25.)

By Mr. Mackay:

Q. I think you also referred to 50 stocks that you took. Have you got a copy of that?

A. Yes, sir, (producing.)

Mr. Mackay: If your Honor please, I think it would help clear the situation up if we put in a copy of the 50 stocks that he has referred to.

By Mr. Mackay:

Q. Have you got an extra copy of those?

A. The reporter yesterday took a copy.

The Court: Very well. The list of stocks may be handed to the clerk, marked Petitioner's Exhibit 26, and received in evidence.

(The stock list referred to was marked and received in evidence as Petitioner's Exhibit No. 26.) [286]

By Mr. Mackay:

Q. Did you make any further checks on your estimated value of the stock of the Dominguez Estate Company?

(Testimony of Jonathan B. Lovelace.)

A. Yes, I think I was just indicating that I was using the earning power basis as a check against the valuation of \$418.00, which has been established on an asset basis, discounting the net asset value at market to be in line with other securities available in the market at June 5, 1941, and I was adjusting the earnings to get an earnings period that could be compared with the 40 or 50 stocks that I listed. I am not sure it was put in the record, and if it is not, I would like to say now that if we value the 1940 earnings as the average of the stocks listed in the table, the value becomes \$216.00. If you value it at 8.2 times the average earnings for the five-year period, it becomes approximately \$438.00, and I considered that range—the lower range would indicate the excess valuation and I considered the range from \$215.00 to \$437.00 as being the summation of the valuation of \$418.00 by indicating it slightly on the high side.

The next step is always what the future earnings may be and compared with cash earnings, because an investor who buys securities is really only interested in what he is going to get in the future, and the past is simply an index or indication on which he can base that estimate.

In the case of the Dominguez Estate Company, by reason [287] of the stipulation of the future income to be received from the oil royalties, it is possible to make a forecast of the trend of earnings in the next ten years as compared with the past ten years. The stipulated exhibits show that in the

(Testimony of Jonathan B. Lovelace.)

ten years ending in 1941 Dominguez Estate Company received oil royalties of \$8,655,000.00 and the exhibit—I think it is 12-K—our future income from oil royalties shows that in the next ten years the company will receive \$6,062,000.00, so there is a difference of \$2,590,000.00, the company is going to receive \$2,590,000.00 less in oil royalties on the basis of the stipulated rate of income in the next ten years than they received in the past ten years. But, if you take that figure and adjust it for the oil royalty income—I mean, the depletion charge of $27\frac{1}{2}$ per cent—you get a net decline in net earnings of \$1,880,000.00 over the next ten years. In other words, the actual decline in oil royalty income of \$2,593,000.00 would only result in a reduction in earnings of \$1,880,000.00. That is an average of \$188,000.00 a year, and that amounts to \$17.91 per share of Dominguez stock, so that on the basis of the stipulated figures, if the other operations of the company were precisely the same as they had been over the last ten years, then the earnings of the company in the ten years after 1941 would be \$17.91 a share less than the reported earnings. If you take the ten year earnings as \$45.00, your estimated earnings for the next ten years would be [288] \$27.05. So, the figure of \$418.00 is rather liberal capitalization for anticipated future earnings of \$27.00 a year. In fact, that is 15 times earnings.

The figures can be shown graphically. I made a chart——

Q. Can you explain the chart?

(Testimony of Jonathan B. Lovelace.)

A. Yes. This chart——

Q. Stand up and show it so the Court can follow it, and counsel, too.

A. (Complying) This begins with the year 1932 and runs to the year 1941, and the line here of Adjusted Income shows the net income adjusted for depletion in 1932 was about \$36.00. It went up to \$68.00, and down to \$30.00 in 1941. The dividends which were less than the earnings back in the early years are now greatly exceeding earnings, shown by the spread in the red line here. The gross oil royalty income per share—all these figures are on a per share basis; I took the actual oil royalty and divided it by the number of Dominguez shares outstanding. In 1932, for example, it was about \$58.00—\$57.10. The oil royalty income per share of common stock before the final balance even with the adjustment I made was only about \$36.00 a share. Taking this oil royalty income as \$60.00 per share in 1932, it ran up to \$121.00 a share in 1938, and it has since declined from \$121.00 in 1938 down to \$70.00 per share in 1940. At the time of this appraisal the [289] rate was running at about \$70.00 a share in oil royalties, and the stipulations are—oil royalty income would advance from 1942 into the year 1943 up to \$90.00 a share, and thereafter there would set in a steady decline of \$90.00, \$60.00 and on down to \$30.00 a share by 1951. That is a declining picture in the stipulation as to the income from oil royalties.

Mr. Mackay: If your Honor please, we would

(Testimony of Jonathan B. Lovelace.)

like to offer this in evidence. It is merely explanatory.

Mr. Melville: No objection. May I have a copy of it?

Mr. Mackay: We will make a copy.

The Witness: Could I have it done better?

Mr. Mackay: We can withdraw it.

The Witness: It is rather crude. It is just my own study and I would like to have it made better.

Mr. Mackay: Would you object to that, Mr. Melville?

Mr. Melville: No, not at all.

The Witness: I will bring the other back for a check to see it is the same.

The Court: Well, we can assign an exhibit number to this particular chart and we will refer to it as Petitioner's Exhibit No. 27. The chart now in the courtroom need not be marked but when you bring the other chart in, it may be handed to the clerk and marked Exhibit No. 27 and received in evidence. We are receiving it subject to its being produced and handed to [290] the clerk. We will not take any further formal action on it unless it becomes necessary to do so.

(The chart referred to was marked and received in evidence as Petitioner's Exhibit No. 27.)

Mr. Mackay: If your Honor please, the witness referred to a number of companies here, the Consolidated Investment Trust, the Lehman Corpora-

(Testimony of Jonathan B. Lovelace.)

tion, the National Bond and Share Company, and the Los Angeles and Shawmut Association, and all the figures have been read into the record. If it would assist the court in any way we would be very happy to submit this as merely explanatory of it.

Mr. Melville: Yes, I think that is agreeable.

The Court: Very well, it may be handed to the clerk and marked Petitioner's Exhibit No. 28, and be received.

(The document referred to was marked and received in evidence as Petitioner's Exhibit No. 28.)

By Mr. Mackay:

Q. Now, Mr. Lovelace, is that all you have to say with respect to the stock of the Dominguez Estate Company?

A. I would just like to add in conclusion that the result of the forecast which is based on the stipulated figures of the declining earnings for the next ten years compared with the past ten years—there was nothing in that study to indicate that the value of \$418.00 should be adjusted upwards. If anything, there was an indication it should be lower as indicating [292] a rather liberal capitalization. Nevertheless, I did not influence my figure but stood on the figure of \$418.00 a share.

Q. As the fair market value on June 5, 1941?

A. Yes.

Q. Now, did you also make an analysis and appraisal of the stock of the Francis Land Company as of that same date?

(Testimony of Jonathan B. Lovelace.)

A. I did, and I found that the net asset value of Francis Land Company was \$459.29 per share. I arrived at that figure by taking the assets, the fair market value of the 549 shares of Dominguez Estate stock at \$418.00 a share——

Q. You mean, 5,499?

A. Yes, 5,499 shares. At \$418.00 per share that amounted to \$2,298,582.00. The liabilities of the company exceeded the other assets by \$2,109.00. Subtracting that excess of liabilities over assets from the fair market value of the Dominguez Estate, we arrived at a figure of \$2,296,473.00, and dividing that by the 5,000 shares of stock outstanding, we arrived at a net asset value of \$459.29. On that story of statement of assets and liabilities, I placed the fair market value of the Francis Land Company's stock at \$367.00 per share. That is a discount of 20 per cent from the actual net asset value based on the balance sheet in adjusting the Dominguez stock to the estimated fair market value that I placed on the holdings. It is well recognized that any company that is removed from the [292] assets, particularly a corporation, the shares of that corporation are subject to some discount as against the underlying assets. In the figures that I presented yesterday, the table that has been entered as an exhibit, it shows that the most liquid companies, the Lehman Corporation and the National Bond and Share, on the New York Stock Exchange were selling at an average discount of 30 per cent, but in this case I felt that a discount

(Testimony of Jonathan B. Lovelace.)

of 20 per cent was proper rather than applying even the minimum discount prevailing on the listed securities because of the nature of the holdings and because of the fact that Francis owned over 52 per cent of Dominguez. I felt that with that holding it would probably—that the fair market value would be subject to a less discount than would be the case on even the most liquid security. Such a holding is subject to a discount, first, because of the income flows through it is subject to a second tax. 15 per cent of the dividends are taxable at whatever rate is prevailing. The rate of 30 per cent applied to the 15 per cent of the dividends mean you lose in the taxes alone $4\frac{1}{2}$ per cent of the income from the top company. In addition, you have some minor expenses of operation, and investors obviously would only be interested in this stock at a discount from the asset value because if they were going to get it without a discount, they would rather buy the top company. I placed a discount of 20 per cent, which I think is the minimum that would be applied between the willing buyer and the willing [293] seller to the net asset value as computed.

Q. Did you also make a valuation of the stock of the Carson Estate Company?

A. I did.

Q. As of that same date?

A. I did. I took the figures as stipulated, the balance as of May 31, 1941, and added in the value of the oil properties at their stipulated values, as

(Testimony of Jonathan B. Lovelace.)

stipulated in court yesterday, which was \$285,000.00, and then I added the fair market value as I had appraised it on the stock of the Dominguez Estate Company and the fair market value of the stock of the Francis Land Company, and got balance sheet figures as follows: Current assets at stipulated values, \$201,936.00; ranch real estate at stipulated values, \$446,418.00; other real estate, at stipulated values, \$147,200.00; oil properties, at stipulated value, \$285,000.00; investments, at fair market values at June 5, 1941; 1,353 shares Dominguez Estate Company stock at \$418.00 per share, total \$565,554.00; 1,785 shares of Francis Land Company stock at \$367.00 a share, \$655,095.00; total assets, \$2,301,203.00; current liabilities, \$34,158.00; net assets, \$2,267,045.00; equivalent per share on 7,427 shares of common stock, \$305.89.

On the basis of that net asset value of \$305.89, I established a fair market value of \$214.00 per share as a fair market value of Carson stock. [294]

Then I check those figures with the earnings of Carson, taking the stipulated figures with respect to their income and their expenses and adjusting the figures for actual earnings of Dominguez and the actual earnings of Francis Land Company, and I found the earnings for the ten years of the Carson Estate Company average \$161,212.00. That is at the rate of \$24.75 per share. Those figures include an average of \$3.00 per share in profits from the sale of capital assets, but taking the total earnings of \$24.75, the price of \$214.00 is about nine

(Testimony of Jonathan B. Lovelace.)

times the average earnings of the past ten years.

If you take the future picture, it is quite unfavorable as compared with the past ten years both because of the reduction in Dominguez earnings and, secondly, the reduction in Francis earnings as shown by the projected decline in oil income over the next ten years compared with the past ten years. Then there is a further adjustment necessary because the Carson oil properties themselves are stipulated to produce less income in the next ten years than they produced in the last ten years.

Making those adjustments and assuming that the other income of Carson was the same in the next ten years as in the past, it looks as if the future earnings would be about \$13.00 to \$14.00 a share, and the valuation of \$214.00 is a liberal capitalization of that.

So, after checking on the basis of past earnings and [295] on the basis of anticipated future earnings, the figure of \$214.00 which I arrived at on an asset value basis appeared to me to be a sound value.

Q. And, so, is that your opinion as to the fair market value? A. It is.

Mr. Mackay: You may take the witness.

Cross Examination

By Mr. Melville:

Q. Mr. Lovelace, as I understand it, your principal experience has been with investment trusts since 1931? A. Yes.

Q. Have you had any experience in the oil industry? A. Not as an operating man.

(Testimony of Jonathan B. Lovelace.)

Q. What experience have you had in the oil industry? A. In analyzing oil securities.

Q. When you speak of oil securities, what kind of oil securities do you mean? Standard Oil? Texas Company? Those that are traded on the New York Stock Exchange?

A. Local securities, Kern County Land, Honolulu Oil, and securities of companies of a size large enough to command a widespread market for their shares.

Q. Those are the only oil companies that you have had any experience with, valuing the stock of those that are bought and sold on the market? [296]

A. All of which have a market because I have only been interested in securities——

Q. With a market?

A. With a market or market potentialities.

Q. Have you ever dealt in oil royalties?

A. No. I don't know what is the proper answer here, but I did not attempt to appraise the value of the oil royalties. I am appraising the stock of those companies.

Q. I appreciate that. What experience have you had with the stocks of oil royalty companies?

A. I have had a very limited experience in that. There again——

Q. That answers the question.

Mr. Mackay: Let him explain it if he wants to.

The Witness: This company is not an oil royalty company. This company's assets are more outside the oil business than in the oil business. They have

(Testimony of Jonathan B. Lovelace.)

got real estate and stocks and bonds. If I were valuing the controlled stock, I would have quite a different idea from the one I placed. If I were valuing the stock as controlled, it might have a different value.

By Mr. Melville:

Q. You are applying a discount factor because it is minority stock that you are valuing here?

A. Yes, but I would apply a discount even on controlled [297] stock, but I would not apply the discounts I did if the person has the ability to sell these assets at the prices stipulated on them, obviously.

Q. Can you tell the court how much of a discount you have applied because it is minority stock?

A. Well, I applied the measuring stick of what other minority stocks were selling at in relation to their assets.

Q. Putting it in terms of per cent, can you tell me?

A. I did not try to value it as majority stock. I applied the discount of 45 per cent from the assets because I was valuing a minority block.

Q. That was 45 per cent? A. Yes.

Q. Do you know what discount factor you would apply if you were valuing a majority stock?

A. I could not say without a study.

Q. You are familiar with the blockage rule?

A. I am not sure I know all the legal——

Q. Have you testified before in court cases involving the valuation of stocks?

(Testimony of Jonathan B. Lovelace.)

A. Yes, I have.

Q. Have you ever had a real large block to value?

A. Yes, I have had a substantial block to value.

Q. Have you ever discounted it by reason of the fact that it was such a large block, on the theory that if it were [298] dumped on the market all at about the same time it would depress the market?

A. That applies to stocks that already have an established market. You cannot apply that to a company that has no market at all.

Q. I appreciate that. Have you ever had occasion to value the stocks of a company that is listed on the market wherein you were valuing a large block?

A. Not in a court case.

Q. If you were valuing such a block, would you take a discount by reason of the fact that it was a large block?

A. Well, not necessarily from the figures that I have used. The discount you would apply has to be decided in each case. In some cases, if the block were large enough to command competition between investment bankers, you might get actually a less discount if you had a small block which did not offer enough gross profit to interest competition among underwriting firms.

Q. In both cases, as I understand it, though, regardless of its size, if it was a block you would apply a discount factor?

A. Yes, you would have to allow a discount for selling. For instance, on the New York Stock Ex-

(Testimony of Jonathan B. Lovelace.)

change even when the blocks run over \$75,000.00 worth, the commission is not the ordinary stock exchange commission but runs anywhere from two [299] to six per cent, what they call special offerings. It is a new development that has come up because of the limited markets prevailing even on the New York Stock Exchange.

Q. Let us take, for example, now, a small corporation with, let us say, 50,000 shares outstanding of common stock. As I understand your testimony, if you were valuing a substantial portion of that, like 40,000 shares, you would apply a discount because it was a large block, and if you were valuing a small number of shares like 100 or 200, you would apply a discount because it is a minority interest? Is that your testimony?

A. Not in those ratios. You say "a large block" and you mentioned, I think, 40,000 out of 50,000?

Q. That is right.

A. That would be control and that would be quit different. I would consider, if you were selling a block of, say, 10,000 shares out of 50,000 shares, the discount per share might not be as great as if you were only selling 200 shares of the stock.

Q. But it would be a discount?

A. Yes, because there is the cost of marketing securities.

Q. What I am trying to get from you, if I can, is—now, we have got this corporation with 50,000 shares; how many shares of 50,000 would pass between the willing buyer and willing seller without

(Testimony of Jonathan B. Lovelace.)

a discount either by reason of blockage on one [300] side or minority interest on the other?

A. A discount from what, now?

Q. From what you would otherwise say was the fair market price?

A. I have taken no discounts from fair market price. I took a discount from the value of the underlying assets. In other words, the stock of the company is not worth as much as the assets of that company are to the corporation itself.

Q. Didn't you say you applied a discount in this case because it was such a small number of shares, it was not control?

A. But I was not discounting from market value.

Q. What were you discounting from?

A. The net asset value, that is, taking the balance sheet of the company as stipulated and putting in the value of the oil royalties, I came out with a net asset figure, and I said anyone being asked to purchase that stock would only buy it as a discount of 45 per cent from that value.

Q. Fine. So, in valuing a small number of shares, you do take a discount from asset value to arrive at your fair market value? A. Yes.

Q. And in valuing a block of 10,000 out of 50,000, you take a different discount?

A. It would not be radically different from that.

Q. You say it would not be?

A. No, not from that. It might be 40 or 42. I would have to study it.

Q. But it still would be a discount from the asset

(Testimony of Jonathan B. Lovelace.)

value to arrive at the market value?

A. Yes, because the fair market value indicates a willing buyer and willing seller and I do not think anyone would buy into a corporation with a limited market except at a substantial discount from the net asset value. I used the illustration there of the Security Company. There is a company well known in Los Angeles. The president of it is the president of the Security-First National Bank with about \$5,000,000.00 of assets. I have the statement here.

Q. I think you have answered the question. I don't want to cut short your explanation, but I don't want you to take me afield from the line of cross examination that I am pursuing.

A. I would say that your discount would depend upon conditions at the time and the availability of other securities and discounts from their asset values.

Q. You understand I did not ask you the amount of the discount, only the fact that you take a discount? A. Yes.

Q. Let us go up; we have come from 200 shares to 10,000 shares out of 50,000. If you were valuing 20,000 shares, would you take a discount from asset value to arrive at the fair market [302] value?

A. Yes.

Q. Is there any point now, going up the scale, at which you would not take a discount from your asset value either by reason of the fact you have a

(Testimony of Jonathan B. Lovelace.)

small number of shares or by reason of the fact that you have a large block?

A. If you had control and were in position to liquidate the company, if the size of the block was such that it constituted effective control in itself, I would apply a discount based on the cost of marketing the underlying assets and the length of time it would require to convert that into cash, and those discounts run anywhere from 10 to 25 per cent.

Q. So that in all cases, both below and above 50 per cent of the total stock outstanding, you would take some discount?

A. Yes, because there is some cost of marketing those assets. Those assets at stipulated values are the fair market values but not the net amount that can be realized.

Q. What were the names of the oil royalty companies in which you have dealt in their stock?

A. It has been some years and I told you they are not important. It is the Marland Company, I think the name is changed now, and I have not dealt with them for five or six years. I have not been interested.

Q. Have you had any experience in the real estate business? [303]

A. No, not as agent.

Q. Have you ever dealt with stocks of real estate companies?

A. Yes. I checked into one company here just as a comparison on this discount that I had applied. There is a company here called the Central Busi-

(Testimony of Jonathan B. Lovelace.)

ness Properties and that stock has a book value—the Central Business Properties own properties on Hope Street here in Los Angeles and it has a book value, according to the company's books, of \$57.32 a share. It has a net asset value with real estate adjusted to market of \$20.84. In other words, the market value was considerably below the book value, but that figure of \$20.84 would correspond with the stipulated figures that I used here. That stock was selling on June 5th at \$5.50. That is a discount of 73.6 per cent from the fair value.

There is a second company here called the Pioneer Securities Corporation, a company that had net cash assets on May 31, 1941, of \$114,000.00; it had marketable securities of \$63,000.00; real estate on Wilshire Boulevard practically from Grand Street up to Figueroa, which they carried at \$918,000.00, and the fair value of which was placed at \$662,000.00. So, taking the fair value instead of the book value of the real estate, the shares of that company had an asset value of \$47.19, and it was selling on the market on June 8th—no sales on the 5th—at \$14.00 a share, with an asset value, as I say, [304] of \$47.19. So, that stock was selling at a discount of 70 per cent. So, when you get into real estate companies, you find the discount much larger than anything that applies to more marketable situations.

Q. Did you consider those two real estate companies when you were valuing the stock in this case? A. No.

(Testimony of Jonathan B. Lovelace.)

Q. And you gave no consideration to it whatsoever?

A. Not until after I arrived at my value. I used them as a check. I went around to check other companies to see at what discounts the real estate companies were selling.

Q. Did you check any other real estate companies besides these two?

A. No. They were the only ones where I could get an estimate of the fair value of real estate. To get on a comparable basis you would have to have an appraisal made of the properties of the companies. You would not just accept the book values any more than you have accepted the book values of Dominguez.

Q. What values did you use, then, in these two companies? A. Sir?

Q. What values did you use, then, in making the comparison with these two real estate companies? A. I used an appraised value.

Q. Who appraised it? [305]

A. I bought into both of those companies and I had, I think, a fellow named Rolap, I would have to check my records for the name—you asked me if I dealt in them and I was just telling you how we had——

Q. You bought some yourself?

A. Yes. We later bought this Pioneer Securities Company and liquidated the company, and when we bought it and knew it was to be liquidated, we bought at a 20 per cent discount from the values

(Testimony of Jonathan B. Lovelace.)

at that time. That was in the first part of this year.

Q. Did you make a profit on the liquidation?

A. Yes.

Q. Then you have not considered any real estate companies that were operating at a loss, have you?

A. No.

Q. Isn't the real estate that is involved in the Dominguez Estate Company being carried at a loss?

A. Yes, it appears to be.

Q. What do you mean, it appears to be?

A. I don't know what general administrative expense is allocated between the oil—I don't know what costs apply to that.

Q. Haven't you been furnished with a complete copy of the stipulation? A. Yes. [306]

Q. Isn't there an allocation there for you?

A. Yes. I didn't figure it out.

Q. What do you mean, you did not know?

A. I didn't figure it out. It was immaterial to me because if I was evaluating the control of the stock, then I would try to get at the individual situation to see if the real estate could be sold, what it would be sold for, and what the oil royalties would be worth. But here we are evaluating the stock of the company in which the potential buyer must consider it is going to be run just as it has been run in the past.

Q. And you have so considered it?

A. Yes.

Q. Do you have the real estate charted on what has been referred to as Exhibit 27?

(Testimony of Jonathan B. Lovelace.)

A. No, I haven't, no.

Q. Has it been your assumption, then, that the Dominguez Estate Company will continue carrying the real estate and paying taxes and other expenses which might be involved and as a result continue carrying it at a loss? A. I——

Q. Have you assumed that or not?

A. No. I assumed there would be some improvement, but not materially, not enough to offset the decline of earnings on the oil. [307]

Q. What improvement did you assume?

A. I assumed that the future earnings would be about, I think, \$8.00 a share per annum in the next ten years better than they would have been, adjusting for the decline in oil income, but I felt that would be more than offset by higher taxes. In 1941, you will recall we were faced with substantially higher taxes, and all the evidence of that time, the demands of the Treasury and the President, were towards higher taxes, and I felt that the higher taxes which we were faced with from 1941 on would more than offset any improvement in the real estate situation.

Q. Is it not a fact that the principal reason why real estate is being carried by this company at a loss is because of taxes?

A. I don't know that to be a fact, no.

Q. Would taxes be reflected in the carrying charges with respect to the real estate?

A. You mean the cost of—you mean the property taxes?

(Testimony of Jonathan B. Lovelace.)

Q. Yes.

A. I was not talking of those. I was talking about federal income taxes and the state franchise taxes which are based on the net income of the corporation. The property taxes are part of the operating expense. I don't know of any reason to assume that property taxes would be lowered, but I was not speaking of increases there. I was speaking of increases [308] in the corporate income tax rates.

Q. Now, Mr. Lovelace, it is a fact that this real estate was being carried at a loss? A. Yes.

Q. And since you would assume that it was not likely that the property taxes would be decreased, and since it is reasonable to assume that income taxes would be increased, why did you assume that the corporation would not continue carrying this real estate at least the loss that they had been carrying it at prior to 1941?

A. I assumed that there would be some improvement in income. I had no reason to assume that they would not continue to carry the properties, but I thought there should be some improvement in the operating situation.

Q. Isn't it fair to assume that the very fact that a corporation carries real estate from year to year and pays taxes on it—that it is doing so for what they consider to be inevitable appreciation in the value of that real estate?

A. In the opinion of that particular management, yes, but there are differences of opinion.

(Testimony of Jonathan B. Lovelace.)

Q. If they had thought otherwise, they would dispose of it, wouldn't they?

A. There might be other reasons of tax consideration that I would not know about, but I would think that if they thought it was going to go down, they would dispose of it. [309]

Q. Doesn't it inferentially follow that the fact that they hang on to it indicates they thought it was going to go up?

A. Yes, I presume so, but in that connection the stipulated values have been put in as to the value of the real estate, and that is a good deal less than the cost. There is a tendency of a lot of people, when they pay a high price for something, to hold onto it until they get that price back without considering the relative values.

Q. Don't you understand that the stipulated fair market value of that real estate is the value at which it could have been turned into cash on June 5, 1941?

A. Yes, but it was not.

Q. That is right, and the fact that it was not indicates to you just what?

A. Well, that the management believed in that real estate and thought eventually it would be worth that much or more.

Q. Correct. Now, besides real estate what are the other—withdraw that, please.

Are you familiar with the profits the Dominguez Estate Company made from subdivision operations in the years prior to 1941?

A. I made no study of it because I took the pic-

(Testimony of Jonathan B. Lovelace.)

ture of the company as a whole, the picture of the earning power that [310] came out of that situation as it exists.

Q. You didn't even know, then, that they did make profits from subdivision of their real estate?

A. Yes, I saw some profits; I did not know what they came from.

Q. You did not consider it?

A. I did not consider it because you had already said what the fair value of that was.

Q. Besides real estate, now, what other activities does the Dominguez Estate Company carry on?

A. Well, the assets consist of current assets, the ownership of stocks and bonds, the two classes of real estate, and the ownership of oil royalties.

Q. And how would you compare them, now, with each other with respect to their relative importance?

A. Well, as at June 5th, taking the stipulated values of the current assets, stocks and bonds, real estate, and the value of \$3,000,000.00 for the oil royalties, the total would be \$7,979,000.00, so that the oil situation would be about $\frac{3}{8}$ per cent, a little less than 40 per cent of the total.

Q. How about real estate?

A. Well, I am just figuring this in my head, now.

Q. I don't want you to figure out the percentages. Which would be the most important to the Dominguez Estate Company, their oil royalty interests, their real estate, or their investment [311] in marketable securities?

(Testimony of Jonathan B. Lovelace.)

A. Well, on an asset value basis their real estate would be more important, on the basis of stipulated values. On the basis of earning power, the oil is more important to them.

Q. Now, didn't you find it a little difficult to value the stock of a company whose most important activity is real estate where the real estate is being carried at a loss?

A. No, I was taking the earnings of the company as a total, the final net income shown from operations, because I felt that this block was not a block that could either change the management or order the sale of any particular items that it had.

Q. And you applied the same discount factors, then, capitalization factors to each and all of the assets?

A. I did not apply any discount to the assets. I applied the discount to the net assets of the company as a whole.

Q. That is what I mean.

A. Just as if someone—I would like to use the comparison again of the Security Company. The assets of that company consist of real estate of \$1,100,000.00, marketable securities of \$3,000,000.00, and that worked out to a total book value there, total net asset value with everything valued at the market, and then I compared the market price of that to that value and saw that the discount was 39 per cent—38 per cent—so, I said, “Here is a company with assets of \$67.60 [312] a share, its assets not as liquid as those of the Security Com-

(Testimony of Jonathan B. Lovelace.)

pany," and I said that the discount obviously should be higher than that of a readily marketable security in a very productive situation in which almost all of the assets were earning money at that time, and I applied the discount of 45 per cent.

Q. To the assets as a whole? A. Yes.

Q. Disregarding the fact that if those assets there were stocks and bonds which are marketable, high grade stocks and bonds, on which the interest rate would be—how much would you say?

A. Well, probably 4 per cent on an average. In 1941 it would be higher than that, probably 5 or 6 per cent.

Q. Do you think this corporation is getting 5 or 6 per cent on the grade of bonds and stocks that they are carrying?

A. In 1941 values, they should be getting close to that. The list that I recited shows that in 1941 those stocks were yielding over 9 per cent, 9½ per cent. They were all very high grade stocks, General Motors, Chrysler, Chesapeake & Ohio, Union Pacific, Pennsylvania Railroad. If you figure the yield on the market at June 5th, I would think that if they were not getting over five per cent it was not being aggressively managed.

Q. I believe you testified, then, that of the three departments, real estate was of the most important, oil royalties [313] second, and of least importance were the investments in marketable securities?

A. I said on the asset value basis. I said that

(Testimony of Jonathan B. Lovelace.)

on the earnings basis the oils were much more important.

Q. Now, Mr. Lovelace, if you were to value a personal holding company that had \$1,000,000.00 capitalization, and all of the stock was in the hands of a small group of individuals, a family corporation, let us say; they had just formed the corporation and they had not gotten around to making any investments yet, the \$1,000,000.00 was in the bank in a savings account drawing one-half of one per cent interest, how would you value that corporation?

A. You mean at June 5th?

Q. No.

A. Well, the value would depend on the time because it depends on the attitude of the investor.

Q. I am after your methods. I don't want to relate this back to June 5th, necessarily. You can take June 5th or today, whichever you like.

A. I would have to relate it back because the discount that people require to go into a frozen situation varies with their sentiments.

Q. Then let us go back to June 5, 1941.

A. On June 5, 1941, investors were not in a frame of mind—if the money was in the bank they would be afraid of any [314] attempt to put it into some unwise venture, and I think they would require a substantial discount. I think they might require more, because in 1941 a tremendous premium was paid on liquidity.

Q. These assets were liquid.

A. Yes, but the others you asked me to value

(Testimony of Jonathan B. Lovelace.)

are not liquid. I am not quarreling with the value of the money in the bank or the values that have been arrived at here, but I say if a man has a share in there—it is just as if three of us own a piece of property, if one of us does not have the right to sell it, it is not worth as much to us as if we controlled the property because we have to stand by the results of somebody else's decision.

Q. Let us say within the family. Supposing you and your wife and your father and your mother and your children owned the stock of this corporation and they have got \$1,000,000.00 in the bank drawing one-half of one per cent of interest on June 5, 1941, what is that stock worth?

A. To whom? To a willing buyer?

Q. To the people that own it?

A. To a willing buyer—if the people that own it, enough of them, have a right to liquidate it and take their money out, then it is worth asset value, but if the man is in a minority position, it is worth what he thinks will be the ultimate results of that employment of those funds. [315]

Q. How would you go about valuing the stock of such a corporation?

A. Well, it would be rather difficult without knowing what the corporation was going to do, and this is a rather unusual situation.

Q. It is your stock, you and your wife and your father and your mother and your children own it; you are not going to sell it unless you can get what you think it is worth. If a willing buyer comes

(Testimony of Jonathan B. Lovelace.)

along and offers you a price and you don't think that is enough, you will not sell it, and therefore there will not be a sale, isn't that right?

A. Yes.

Q. The only time a sale will occur is when the willing buyer comes up to the price that the willing seller is willing to take for it? Right?

A. Yes.

Q. All right, now, it is your stock; how would you value it and what would you sell it for?

A. You want to get what the willing buyer would pay for it?

Q. No.

A. If it was June 5th and I had that situation, I would sell at a substantial discount because I could see I could use the money in other situations. When you buy Lehman Corporation, you are buying cash in the bank, securities that can be sold [318] overnight, you are actually buying the same thing you are talking about and you could buy it at a 29 per cent discount.

Q. How much would you take for the stock you were owning in this company?

Mr. Mackay: Will you clarify that, how much stock is he owning?

Mr. Melville: He can assume any figure he wants to.

The Witness: If I had control I would not take any discount. If I were a minority stockholder and did not know what the policies of the company were going to be——

(Testimony of Jonathan B. Lovelace.)

My Mr. Melville:

Q. Let us assume all the facts that I have previously stated now with respect to this family group, and let us assume that you owned out of 10,000 shares representing this \$1,000,000.00 worth of assets—let us assume that you own 200 shares.

A. Well, I would take a discount of around 25 to 30 per cent.

Q. You would be willing to sell for that?

A. I would.

Q. Let us assume that your father owned 5,000 of the 10,000 shares; what would that stock be worth to him?

A. Well, what state is it incorporated in? If it was in Delaware, it would not be worth much.

Q. California. [317]

A. A California corporation? I think 50 per cent would liquidate.

Q. Well, let us make it 55.

A. Then I would say it would be worth face value to him less whatever the cost of clearing the money out through the bank.

Q. That is, it would be worth——

A. About 99 per cent, probably.

Q. 99 per cent of the asset value back on the stock? Right? A. Yes.

Q. If it is worth that much to him, why wouldn't he pay you that much for your 200 shares?

A. Well, he has all he wants. He has the control.

Q. If it is worth that much to him, he would be

(Testimony of Jonathan B. Lovelace.)

getting a bargain to get 200 shares more at the price you would be willing to sell for?

A. Possibly he would. It is a hypothetical case.

Q. Yes, but that is what we are dealing with.

A. I think he might say—he would probably say, “Son, I hate to see you take this loss, but if you want to sell it at a 30 per cent discount, I will buy it from you.”

Q. Knowing full well it was worth 100 per cent or 99 per cent? A. To him. [318]

Q. Is it not a fact that the market in stocks is made by willing sellers who are desirous of getting the highest price possible and by willing buyers who are desirous of making as good a buy as possible? A. Yes.

Q. All right. Now, you have stated what you thought the stock was worth in your hands, you would take a 25 per cent discount; you have stated what you thought you father would figure it was worth in his hands, 99 per cent of the asset value; now, you are going to sell that stock to your father, you know what it is worth to him, would you sell it for a 25 per cent discount?

A. Yes, because I would be selling it because of what I could do with the money somewhere else.

Q. Wouldn't you sell it for the highest price you could get?

A. I might say that I thought I ought to get a little more, but you asked what I would take for it and I said I would take a discount of 25 to 30 per cent, and be glad to get it. When you speak

(Testimony of Jonathan B. Lovelace.)

of the willing buyer and the willing seller, both the willing buyer and willing seller are both greatly influenced by the conditions prevailing at the time they meet. We had a case in 1929 where the Lehman Corporation had what you said, the cash in the bank, and the stock sold at approximately 40 per cent discount because people thought they could do magic [319] with it. In 1941 there was a great apprehension on the part of investors that it was the end of the capitalistic system. There was a great fear in those times and people wanted control of their own funds and they required a very large discount to go into any non-liquid situation.

Q. Were you talking about Lehman Brothers?

A. Lehman Brothers. It is now selling at a discount of 29 per cent.

Q. What business are they in?

A. The business of buying and holding bonds and stocks.

Q. Investment trust? A. Yes.

Q. Is the Dominguez Estate Company an investment trust?

A. No, it is a personal holding company.

Q. And it is not an investment trust?

A. Not within the meaning of the Act. The only reason it is not is because the Act excludes personal holding companies. It would be called an investment trust but there happens to be a legal definition of investment trusts in the Securities Act.

(Testimony of Jonathan B. Lovelace.)

Q. In your opinion is it comparable to an investment trust?

A. Reasonably comparable, yes.

Q. Do you know any other investment trusts that derive their principal income from oil royalties?

A. Yes—not royalties. Oil securities. The Petroleum Corporation of America buys and holds nothing but oil stocks.

Q. But they are not deriving their principal income from oil royalties?

A. From oil profits.

Q. I am asking you about oil royalties.

A. Not to my knowledge.

Q. You don't know of any investment trusts that derive its principal income from oil royalties?

A. No.

Q. But this Dominguez Estate Company that we are dealing with does derive its principal income from oil royalties?

A. Yes.

Q. So they are not very comparable, are they?

A. Every investment trust differs in the type of things it invests in. As a general type, they are reasonable comparable.

Q. Do you know of any investment trusts that hold large amounts of city and ranch real estate?

A. Not offhand. I know a good many of them that did and all of them disposed of it.

Q. Is it not a fact, Mr. Lovelace, that only to the extent that the Dominguez Estate Company holds marketable securities is it similar to——

A. No, to the extent that it holds assets for

(Testimony of Jonathan B. Lovelace.)

investment [321] purposes. This is similar from the standpoint of the ownership of the real estate, securities, and oil royalties. You will find some investment trusts that will be just that way except that one may own RKO Theater, and another may own just one particular thing. The companies I used all had broad lists of securities, practically the same as cash.

Q. All of the investment trusts you had in your comparison hold nothing but marketable securities?

A. That is right.

Q. Isn't that true of most investment trusts?

A. Well, most in number but possibly not in size. I would have to check on that.

Q. But you did not make any comparison with the others?

A. Yes; the discounts on the others run higher, most of them, than these I used.

Q. You did not use any others except the investment trusts that held only marketable securities?

A. At this ratio, no.

Q. In this comparison?

A. That is right. I just testified that where I did find a company that owned city real estate, the discounts were much larger.

Q. What investment trust holds city real estate?

A. Pioneer Securities, that I referred to. Its assets were practically half in real estate, and the real estate was [322] all earning good money, making a good return.

Q. Is that an investment trust?

(Testimony of Jonathan B. Lovelace.)

A. It was an investment trust in every extent except a technicality. It was technically called a personal holding company also, but it owned marketable securities and—I gave the figures just now. It had \$114,000.00 in cash assetss, \$63,000.00 in marketable securities, and \$918,000.00 in real estate on Wilshire Boulevard.

Q. You think that a comparable corporation to the Dominguez Estate Company?

A. Well, nothing is strictly comparable, no. This discount is 70 per cent and I only applied a discount of 45.

Q. Did you consider that company in arriving at your discount of 45?

A. No; I checked it afterwards. I did not take it into account at all in arriving at the discount. If I had, I would probably have used a larger discount.

Q. Is the Dominguez Estate Company what you would call a family holding company?

A. Well, I say it is a greatly mixed up holding company in this whole situation.

Q. In your opinion, it either is or is not a family holding company. Just answer the question.

A. I think it probably is. I did not study it from that angle. [323]

Q. Have you ever considered the stocks of other family holding companies to ascertain the fair market value of them?

A. Well, the nearest to this, as I said, is Pioneer Securities. That I considered to be an investment company, but technically it was rated as a family

(Testimony of Jonathan B. Lovelace.)

holding company because the control was owned by Lee A. Phillips Corporation, in much the same way that Carson owns the control of Dominguez.

Q. Is it your understanding that Carson owns Dominguez?

A. No. It is 55 per cent of the stock, as I recall—no, 52.4 per cent, 5,499 shares. Did I say Carson? I meant Francis. I beg your pardon. I meant to say the Francis Land Company.

Q. What stocks of family holding companies can you name for which you could obtain stock prices as at June 5, 1941?

A. I don't know of any.

Q. Is the answer "none"?

A. I wouldn't say that. I would say I don't know of any because the market for shares of family holding companies is obviously very limited.

Mr. Melville: Opposing counsel has indicated he would like a short recess.

The Court: Very well.

(A short recess.)

Mr. Melville: Will the reporter read the last question and answer? [324]

(The record was read.)

By Mr. Melville:

Q. It seems to me, Mr. Lovelace, that that question does not have to be qualified in that way. I asked, what stocks of family corporations, if any, can you name for which you could obtain stock prices as at June 5, 1941?

(Testimony of Jonathan B. Lovelace.)

A. I said I did not know of any, but that does not mean there are not any.

Q. Can you name any? A. I cannot.

Q. That answers the question. It follows, then, that you did not make any comparison in valuing the stock in our case, the Dominguez Estate Company, the Francis Land Company, or Carson Estate Company, with the stocks of any other family corporations?

A. No; I said it did compare—after making a study I did compare it with the Pioneer Securities, which is a family holding company technically, controlled by the Phillips Estate.

Q. Is that a family holding company?

A. The Lee A. Phillips Corporation owned over 50 per cent of the Pioneer Securities.

Q. It seems to me that unless you are going to change your testimony, it is not a family holding company, because a few moments ago you stated that you could not name——

A. I said I considered it to be an investment company, [325] just as I considered this was essentially an investment company from the standpoint of the fair market value of the outstanding securities, but, technically, the Security and Exchange Commission says that an investment company is a company which has over 50 stockholders, and it might have all the characteristics in size and everything else of an investment company, but if it does not have over 50 stockholders, then it is not an investment company.

(Testimony of Jonathan B. Lovelace.)

Q. Where did you get your stock prices with which you made your comparison?

A. I got them from brokers, three brokers, and I was following the stocks myself at that time. I know of the transactions that took place. I did not buy the stock. It took place shortly after June 5, 1941, and, as I said, I continued to follow the company and we actually purchased control of the company here about four months ago, and we purchased it at a discount of 20 per cent from the then asset value.

Q. I am sorry, I am not too clear. It either is a family holding company or it is something else. What is it? I am not trying to tell you what it is. I want you to tell the court what it is.

A. Well, it is considered a family holding company.

Q. Then we will go back to the other question, and I think you want to change your testimony. I asked you whether you could name—what stocks of family holding companies can [326] you name for which you could obtain stock prices as at June 5, 1941? Do you want to change your answer?

A. Yes, using the technical definition of the company, I would say that Pioneer Securities, I am advised, is considered a family holding company.

Q. Who owns the stock?

A. The stock is owned, the majority control, by Lee A. Phillips Corporation, and his daughter, Mrs. Arline Morrison.

Q. Do you own some of the stock?

(Testimony of Jonathan B. Lovelace.)

A. Not now. It is all liquidated and wound up.

Q. Did you own some of the stock?

A. No; my corporation did.

Q. How much stock was outstanding in 1941?

A. 30,000 shares.

Q. How was it distributed between stockholders?

A. I haven't the stockholders' list at that time.

I think there were about 45 stockholders.

Q. Who held them?

A. I haven't the names. I can get that for you but I haven't—I told you I didn't take that into account in valuing this company.

Q. How much did your corporation own?

A. We made a bid contingent on 66-2/3 per cent accepting it because we wanted to be in position to liquidate, and 66-2/3 per cent was necessary because that was a Delaware Corporation, [327] and 80 per cent deposited, and——

Q. That is not answering my question.

A. What?

Q. How much stock did your corporation own?

A. When?

Q. June 5, 1941?

A. None on June 5, 1941.

Q. Do you know who owned it on June 5, 1941?

A. No.

Q. Then why can you say that it was in your opinion a family holding company?

A. Because of the record of the company. I said I am advised that it was. We were told by lawyers in 1945 that it was a personal holding company and

(Testimony of Jonathan B. Lovelace.)

they gave a list of the stockholders, and there has been no change in the situation since 1940.

Q. Are you using the terms "personal holding company", "family holding company", and "family corporation" as synonymous?

A. Well, I was using them in roughly the same category. If by a family holding company you mean a personal holding company which members of one family control, then it is the same thing.

Q. You would call Dominguez Estate Company a family holding company, wouldn't you?

A. It is a personal holding company in which members of [328] the family directly or indirectly have control.

Q. Didn't you base your asset valuation of Dominguez Estate Company on a comparison with five investment trust companies?

A. That was one element of valuation on the asset value basis. Then I valued it in comparison with the other stocks available on the New York Stock Exchange in relation to their 1940 earnings and their 1936 to 1940 average earnings. I found, on the basis of the 1940 earnings, if you valued Dominguez the same as these leading stocks on the New York Stock Exchange, it would have been worth only \$215.00, but I found on the basis of the average earnings it was worth \$437.00, and within that range I took nearer the higher value.

Mr. Melville: I might suggest, your Honor, that if the witness would answer the questions and then stop—I don't mind him explaining, he can explain

(Testimony of Jonathan B. Lovelace.)

all he wants, I have as much time as anybody, but when I ask a question, he might as well answer it and then stop. If he wants to make an explanation, he might ask to explain it.

The Court: Well, we are getting along reasonably well. Sometimes the witness will elaborate too much.

Mr. Melville: I am agreeable. The more he talks, the better off I am, I think.

The Court: The witness will, so nearly as possible, answer the question directly and stop. [329]

By Mr. Melville:

Q. And of those five investment trust companies which you considered, what is the percentage of market value of their stocks to the book value of their assets?

A. The market value of the stocks of these investment trusts to their——

Q. To their book value of assets.

A. What do you mean by the book value of their assets?

Q. Did you consider, in making your appraisal, five investment trusts? A. I did.

Q. Did you consider the book value of their assets, yes or no?

A. I don't know what you mean by book value.

Q. Did you consider in any way the value of their assets?

A. I took the value of their assets at market on March 31, 1941, and the market value of their assets taken item by item and adding them up, I

(Testimony of Jonathan B. Lovelace.)

arrived at a net asset value figure per share. It is on that table I gave you.

Q. What are you going to make a comparison with now? The question was, what the percentage of market value on their stocks were in comparison to the book value of their assets.

A. The value of the assets—let us take one company. The Security Company had certain assets——

Q. What was the value of the assets?

A. That is the figure per share given you there.

Q. In other words, is it your testimony that in valuing an investment trust, the value of the assets is exactly the same as the market value of their stocks?

A. That is the value of the underlying assets, yes; what we call net asset value.

Mr. Mackay: Did you want to see this exhibit?

The Witness: Yes, I would like to see it.

(The paper was handed to the witness.)

The Witness: In other words, take the Security Company, it had certain cash and you take the cash value of that.

By Mr. Melville:

Q. No discount?

A. Not in that instance.

Q. All right.

A. Then we take the appraised value of the real estate.

Q. I thought you said before that you did not know any investment trusts that owned real estate?

A. No. You asked me where the majority of

(Testimony of Jonathan B. Lovelace.)

the assets were real estate; your question was, a company in which the majority of the assets consisted of real estate.

Q. And you are now talking about some investment trusts that have real estate? [331]

A. The Security Company, yes, sir, right here in Los Angeles.

Q. Is it the real estate which they occupy for office space?

A. No, it is for investment purposes. You take the cash they had on hand, and we take the real estate at an appraised value.

Q. Who made that appraisal?

A. The management of the Security—the Board of Directors of the Security Company.

Q. The Board of Directors made the appraisal?

A. Yes.

Q. What is that appraisal supposed to represent?

A. It represents the fair value of the real estate, which was \$152,000.00 below the book carrying value. They carried it on the books at \$768,000.00, and they appraised the value at \$152,000.00 less than that.

Q. And you accepted that appraisal in making your study?

A. Yes. We used—excuse me.

Q. Then, to what extent is your opinion based upon the opinion of the Board of Directors?

A. Of the assets owned by the Security Company, the real estate amounted to less than 10 per cent of the total assets, and to the extent I took

(Testimony of Jonathan B. Lovelace.)

the value of the real estate, comprising ten per cent of the assets, I took the opinion of [332] somebody else with respect to that much of the assets. You asked me how it added up. Then we took the securities at the market value, taking only the bid price for every asset they owned, and we added those up and subtracted the liabilities and divided by the shares outstanding, and that is the way we arrived at the figure of \$48.36.

Q. You have the sheet in front of you, haven't you? A. Yes.

Q. What is the value of the assets?

A. I have not got the precise figures—I have not got my work sheets—but the assets were \$5,700,000.00.

Q. Is that the book value?

A. No, that is asset value based on the fair market value of the independent items.

Q. Do you have book value? A. No.

Q. Then you cannot answer my question as to the percentage the market value of their stocks is to the book value of their assets?

A. No. That is the reason I asked you to define book value, because book value in the case of an investment company would mean the cost of those securities to that company.

Q. Did any of the five companies with which you made comparisons have bonds or preferred stock outstanding, yes or no? [333] A. No.

Q. I believe that in your direct examination you

(Testimony of Jonathan B. Lovelace.)

selected about 50 companies for your earnings basis of valuation? A. Yes.

Q. How many of those companies were oil royalty companies? A. None.

Q. How many were real estate companies? A. None.

Q. How many were oil producing companies? A. Five.

Q. Were those also oil refining companies? A. Yes.

Q. Do you consider an oil refining company and an oil producing company comparable to the Dominguez Estate Company?

A. No; I was not making that comparison.

Q. How many had outstanding preferred stocks?

A. I would have to compute it. I don't know.

Q. Do you think that most of them did?

A. My guess would be that most of them did not.

Q. I presume your answer of "I don't know" would apply to the question about their outstanding bonds, debentures, mortgages, and other indebtednesses? [334]

A. I can give you item by item.

Q. Have you got it there?

A. Yes, I have got a table that covers all of it. I can work it out.

Q. I don't want you to go into too much detail, Mr. Lovelace. I just want to get the picture before the Court. If you can give me a rough estimate of how many had outstanding funded debts, such as

(Testimony of Jonathan B. Lovelace.)

bonds, debentures, mortgages, and other indebtedness, I would accept your answer.

A. I could not give you that. I would rather go down it item by item.

Q. I doubt that it is worth the time if you don't know offhand. I will withdraw the question.

I believe yesterday you mentioned 9.6 per cent yield, is that correct? A. Yes.

Q. What did you mean by that?

A. That is the dividend rate paid in 1940, or announced for 1941, divided by the market price of June 5, 1941.

Q. Where did you get it?

A. Commercial Financial Chronicle, and checked with Moody's.

Q. And that is the composite of all of these 50 companies that you considered?

A. That is the average of the 50. [335]

Q. The average? A. Yes.

Q. Then you did not—did you or did you not consider the funded debts and preferred stocks in arriving at that figure?

A. No, this is the per share earnings on the stock that a man could purchase. There is no relationship there.

Q. From that you arrived at the 7.1 times 1941 earnings, didn't you?

A. Not from the dividends, no. I took the actual earnings reported in 1940 and adjusted them where there had been a change in the capitalization, and divided those earnings by the market price—divided

(Testimony of Jonathan B. Lovelace.)

the market price on June 5, 1941, by the earnings per share reported in 1940.

Q. And that gave you what figure?

A. About 7 times, 7.2 times, as I recall.

Q. In arriving at that 7.1 or 7.2, you did not consider the funded debts and the preferred stocks in computing that figure, did you?

A. You mean to get the overall times earnings?

Q. Yes.

A. No. The majority of these companies have only one class of stock, like Chrysler Corporation, and so on.

Q. Do I understand, then, that you made your comparison on the basis of the value of the common stock only, rather than [336] on the basis of any bonds or preferred stock which those corporations may have had outstanding?

A. That is right. That figure arrived at that way was \$216.00.

Q. Mr. Lovelace, if you were considering two houses, each worth \$10,000.00, would you consider that full ownership of one was no different than an ownership equity of \$2,000.00 in the other on which there was a \$8,000.00 mortgage?

A. Well, if the mortgage rate were low enough, the \$2,000.00 would be advantageous. I would not consider them the same.

Q. You would not consider them the same?

A. No.

Q. Then why did you not consider—withdraw that question.

(Testimony of Jonathan B. Lovelace.)

You would consider, then, the mortgage in determining your fair market value?

A. Fair market value of what?

Q. The house.

A. The mortgage is part of the value. The mortgage is a liability, it is not part of the value. If you value the house and deduct the mortgage, then the equity might be worth a lot more. If the mortgage was low enough and ran long enough, it might be worth a lot more than if it had no mortgage.

Q. Let us assume two houses, and this chair is one and [337] that chair is another (indicating); this house has no encumbrance on it whatsoever, it was just built, completed today; the purchaser of it paid \$10,000.00 for it, he wrote a check and paid cash. This house was also built today, made to the same plans and specifications, and the purchaser did not have \$10,000.00, but that is what he had to pay for this house, so he had to borrow \$8,000.00; he placed a mortgage on his house of \$8,000.00, put up \$2,000.00 cash, and paid off the seller of the house. Both houses are worth, fair market value \$10,000.00 today. What is this house worth?

A. Well, you just told me it was worth \$10,000.00. You said that is the fair value of it.

Q. What would you give for it?

A. I wouldn't buy it, but if it is worth \$10,000.00, then I accept that value.

Q. The house is there now and I am the purchaser. I don't have the \$10,000.00, so I go to the

(Testimony of Jonathan B. Lovelace.)

bank and borrow \$8,000.00 and put up \$2,000.00 of my own and buy it. Now, you were also a willing purchaser of that house, and before I bought it what was it worth? A. \$10,000.00.

Q. After I bought it what was it worth?

A. The house is worth \$10,000.00.

Q. How much would you pay me for my equity?

A. If you borrowed it for 2 per cent interest for 20 years [338] I might pay \$2,400.00 or \$2,500.00. If you borrowed it at 6 per cent for 5 years, I would pay you less than \$2,000.00, because you have done for me what I could do for myself. If you did a better job, I would pay you a premium.

Q. On what basis did you deduct 27½ per cent depletion as from the stipulated income to obtain the income you valued?

A. I wanted to get my earnings for the five year period on the basis comparable with the other securities, the securities listed on the New York Stock Exchange. The earnings were reported after taxes and after depletion and after amortization. Here is a company that, because of its being a family holding company, was following the policy of charging on its books very high depreciation and depletion in the earlier years and no depreciation in the latter years. I have referred to that before. The oil properties have a value estimated or appraised by a previous witness at \$3,000,000.00 That \$3,000,000.00 was the June 5 value of the oil they expect to get out in the future. In the last ten years the company has taken out more oil than it expects to take

(Testimony of Jonathan B. Lovelace.)

out in the next ten years, and yet in the year 1940 that capital asset, which is obviously becoming worth less as value is taken away from it, as oil is taken out, the remaining value is less, yet on the books of the company there was only charged off \$2,000.00 in the year 1940 because they had applied on the books a method of amortizing the [339] cost in the early years.

Now, the real value of any oil income is the earning power, is the income loss, the depletion loss, the amount that is required to charge that item off by the time it is exhausted, and the government allows a formula of $27\frac{1}{2}$ per cent for that purpose.

Q. Do you understand that that $27\frac{1}{2}$ per cent is tax free income?

A. I don't know the answer to that. I understand what is allowed is a depletion charge on which the company does not pay an income tax, or the corporation does not. In other words, the $27\frac{1}{2}$ per cent is an arbitrary figure the government adopted, I understand, to try to permit arriving at the real earnings of the company. Here the company which has an oil property on its books at no value, that is, stipulated at no value on the books.

Q. No; that is at issue.

A. Sir?

Q. That is at issue.

Mr. Mackay: It is on the books.

The Witness: No, on the books at no value, so you could not charge it off on the books if it was carried at no value. Now, obviously, there was de-

(Testimony of Jonathan B. Lovelace.)

pletion and we are appraising it to put a value on the books from June 5th. I don't know whether you put it on the books or not because that is a different [340] thing from the real earnings. If you place a value of \$3,000,000.00 on these oil properties at June 5, 1941, and that is a capital asset, that asset is going to be extinguished during the life of that royalty and has to be charged off so much per annum, and those charges are made against earnings. They may or may not be the precise charge that will be allowed by the federal government, but in order to get the picture of the earnings in the last five years, we had to apply a proper depletion charge to those earnings as they were stated before depletion to get at the real earning power.

By Mr. Melville:

Q. It is your understanding that in arriving at that value of \$3,000,000.00 they gave consideration to depletion of 27½ per cent?

A. No, I have no—I didn't make any study of that at all. I accepted the value.

Q. You don't know whether that value took into consideration 27½ per cent or not?

A. I don't know that. If it does——

Q. Do you know?

A. No, I do not know.

Q. But you arbitrarily have taken another 27½ per cent into account in figuring your——

Mr. Mackay: If your Honor please, I don't want to limit counsel's cross examination, but the witness has so many times said he did it for the purpose

(Testimony of Jonathan B. Lovelace.)

of comparison with other [341] companies, to get a comparison. Here are all the other companies, as he testified, which on their earnings show earnings after depletion, and this is done for the purpose of getting that comparison.

The Court: I am confused on this adjustment on the 27½ per cent depletion. I never got that straight in my mind as to what your theory is on that. Let the witness proceed.

Mr. Melville: I am just as confused, your Honor.

The Witness: I can explain it better by taking the situation from this point, your Honor. On the books of the company the oil property was carried at nothing. Therefore, on the books they could not deplete something that already was carried at zero. Nevertheless, there is obviously a wastage of assets. Now, if we take the situation from June 5th—I think I can explain it—if we put on the books—if we make a balance sheet of Dominguez and put on the books oil royalties at \$3,000,000.00, then by the time all the oil has come out of the ground underlying those royalties, that asset would have to be wiped off the books because it will have no value at the end of that time. So, the \$3,000,000.00 must be written off over the life of the lease.

It is stipulated as to what rate that oil royalty will come in. It is shown on Exhibit 11-K, for example, that in 1942 the company will get from its oil properties \$756,000.00, [342] and it says that up to 1965 it will get \$8,660,000.00, and after 1965 a small additional amount, so that the total royalties

(Testimony of Jonathan B. Lovelace.)

it will get will be something over \$9,000,000.00, \$9,299,000.00.

Now, if it gets back in the year 1942, \$756,000.00, in getting back in that year 8.37 per cent of the total amount of it is going to get back, and if you capitalize this royalty at \$3,000,000.00, then you would have to charge off 8.37 of that \$3,000,000.00 in the year 1942 to keep your books on a proper basis, so that by the time all the oil has come in, the way it is stipulated, you will have written off that value.

The Court: When you take the $27\frac{1}{2}$ per cent adjustment which is allowed simply to a taxpayer to receive that much income tax free, it seems to me that you are making an annual adjustment of $27\frac{1}{2}$ per cent instead of $8\frac{1}{3}$ per cent.

The Witness: $27\frac{1}{2}$ per cent of the oil royalties that came in that year. Let me follow just one step further. I could not do this with respect to the past because we had the record. I apply this 8.37 per cent to the \$3,000,000.00, and that would mean that the actual depletion or amortization required to write off that value would be \$251,000.00 in the year 1942, because that is 8.3 per cent of the total of \$9,000,000.00. Now, if I take that same oil royalty, \$756,000.00, and deduct $27\frac{1}{2}$ per cent of that, which was the arbitrary figure, the deduction would be something over \$200,000.00, so [343] actually the $27\frac{1}{2}$ per cent charge does not write it off as fast as you would be required to do it on the basis of stipulated figures.

(Testimony of Jonathan B. Lovelace.)

The Court: That is only fortuitous. It just happened.

The Witness: That figure was arrived at that way. That is my understanding.

The Court: I don't wish to interfere with the theory of counsel or the witness.

Mr. Mackay: That is all right, your Honor.

The Court: I was just trying to see if I understood it.

Mr. Mackay: We want you to.

The Witness: I am not trying to appraise the oil lands. I am simply saying these earnings as reported should be adjusted to compare them with securities on the New York Stock Exchange. Otherwise, if I were making a comparison in 1932, I would have this company reporting earnings of \$11.00 when the real earnings were a great deal higher.

By Mr. Melville:

Q. Is it your understanding, Mr. Lovelace, that you apply this 27½ per cent to income?

A. That is what I applied it to, yes.

Q. You did?

A. Yes, reduced the royalty income by that amount. [344]

Q. You did not apply it to anything else but royalty income? A. No.

Q. What figure did you use? \$3,000,000.00?

A. No, I took 27½ per cent of the income in that year and that is less than it would have been

(Testimony of Jonathan B. Lovelace.)

if you had capitalized it at the value we are talking about now.

Q. Did you apply the $27\frac{1}{2}$ per cent to the \$3,000,000.00?

A. No. I applied the $27\frac{1}{2}$ per cent in the case of the year 1940—put it this way—let me go back a minute. In the year 1932 this company reported earnings of \$119,000.00. Those earnings were after depletion of \$413,000.00. In that year they received an oil royalty of \$600,000.00. So, I said, to get on a comparable basis, that that \$600,000.00 of oil royalties should not have been depleted to the extent of \$413,000.00, as was done, but should have been depleted to the extent of \$165,000.00. That is $27\frac{1}{2}$ per cent of those oil royalties. So, therefore, the earnings, instead of being \$11.00 or \$12.00 as reported, actually were around \$35.00 in 1932, because of the very heavy depletion. We come down to 1940 and the company shows earnings before depletion of \$4,990,000.00, with only \$2,000.00 deducted for depletion, and I said the depletion should be \$163,000.00, the same as it was back in 1932 and 1933 because the production was the same—\$183,000.00. Therefore, the earnings were understated in the [345] early part of the 10-year period and overstated in the latter part. I did not do this with any idea of appraising the oil stock. It was simply to get the earnings on the basis where it would be comparable with the reports made by listed companies with which I was comparing the investment opportunities.

Q. Now, then, on the income of the Dominguez

(Testimony of Jonathan B. Lovelace.)

Estate Company in 1940, is it your understanding that out of each dollar that they received—correction—out of each \$100.00 that they received, \$27.50 was tax free income and the balance was taxable income?

A. No, I didn't go into analyzing the tax status at all.

Q. Is that your understanding of the 27½ per cent depletion?

A. I have no understanding on the tax status of it. My interest is, at what rate should you allow for depletion of your assets, and thus for a return of capital? In other words, the earnings they reported in the later years included an element of return capital from the standpoint of the investor.

Q. I have had an understanding, right or wrong, of what percentage depletion meant, but I do not believe the record shows that you understand it. I wish you would define, if you can, what the expression "percentage depletion" means?

A. I don't feel in a position to define it.

Q. Well, do you know that percentage depletion deals with [346] a percentage of 27½ per cent?

A. That is the rate, yes.

Q. That is the rate. And you have been using that rate without knowing what it means?

A. I have been using that rate because it coincides with the approximate diminution of the value of this company's assets. I say this, that if a company receives \$600,000.00 from its oil in 1932, and receives \$600,000.00 for its oil in 1941, it is not

(Testimony of Jonathan B. Lovelace.)

reasonable to charge off—it is not reasonable for purposes of comparison to charge off \$400,000.00 in one year and only charge off \$2,000.00 in the other, and I took an arbitrary amount.

Q. So you are taking an arbitrary 27½ per cent just in order to be reasonable?

A. Yes, and I consider it fair. I restated the earnings to get them——

Q. You are not taking the 27½ per cent because it is the law but because it is reasonable? Is that my understanding of your testimony?

A. Yes.

Q. You don't know what it means?

A. I don't know precisely the implication on the tax return, no.

Q. Well, was the 27½ per cent that you took off income—— [347] A. Income to whom?

Q. The Dominguez Estate Company.

A. That they received in 1932?

Q. Let us make this simple, Mr. Lovelace. Let us assume that the Dominguez Estate Company received \$100.00 in oil royalties, and we will just take it at \$100.00 because even a lawyer can understand the percentages in that case. A. Yes.

Q. Now, they received \$100.00 income from oil royalties; apply your 27½ per cent to that, and what do we have? A. We have 72½ per cent.

Q. What was that \$72.50 to the Dominguez Oil Company? A. That is income.

Q. Income? A. Net income.

Q. And what was the \$27.50?

(Testimony of Jonathan B. Lovelace.)

A. That is an amortization of the value of the property to allow for the depletion of its assets.

Q. Not income at all? A. No.

Mr. Melville: No more questions.

Redirect Examination

By Mr. Mackay:

Q. Now, Mr. Lovelace, I think you have stated that the companies which you made a comparison of—that in their [348] statements their earnings show, or their books reflect earnings after depletion, is that right?

A. After depletion and amortization.

Q. And then you were merely making this 27½ per cent deduction here for the purpose of comparing with these other companies?

A. That is right, and it appeared to me that the assets were being dissipated and were being used up at a greater rate than that, but I used that as a figure which I thought was a conservative figure to allow for it.

Q. But the main purpose was to put them on a comparable basis so you could make a comparison? A. Solely for that purpose.

Q. Now, Mr. Lovelace, do you know how long the Dominguez Estate Company has been in existence? A. Since 1910.

Q. It was organized in 1910? A. Yes.

Q. Do you know when the Carson Estate Company was organized?

A. Let me check. I have it. I remember reading it. It was 1914, I believe.

(Testimony of Jonathan B. Lovelace.)

Q. And the Francis Land Company?

A. 1928.

Mr. Mackay: I think that is all. [349]

Mr. Melville: I may wish to examine again. May I have a brief recess, your Honor?

The Court: Very well. We will suspend for a brief recess.

(A short recess.)

Mr. Melville: I believe you said you were through with the witness?

Mr. Mackay: Yes.

Mr. Melville: So is the respondent.

The Court: Very well, you may step aside, Mr. Lovelace.

(Witness excused.)

Mr. Mackay: Call Mr. McFie.

LYMAN R. McFIE,

called as a witness for and on behalf of the petitioner, having been first duly sworn, was examined and testified as follows:

Direct Examination

The Clerk: Your full name for the record, please?

The Witness: Lyman R. McFie.

By Mr. Mackay:

Q. Mr. McFie, what is your occupation?

(Testimony of Lyman R. McFie.)

A. I am manager in Southern California of Merrill, Lynch, Pierce, Fenner & Beane.

Q. How long have you been manager? [350]

A. Since April 22, 1942.

Q. Prior to that time what was your occupation?

A. I was manager in Southern California for Schwabacher Company.

Q. That is a brokerage house?

A. Brokerage and investments.

Q. How long were you manager for them?

A. 12 years.

Q. How long have you been in the brokerage business, Mr. McFie? A. About 16 years.

Q. All that here in Los Angeles?

A. Yes.

Q. You have had occasion, have you, to value stocks of various companies? A. Yes, sir.

Q. Will you please give the court in a brief way your experience along that line?

A. I have acted as appraiser in underwritings of both stocks and bonds. We have acted as agents and brokers in stocks, bonds, commodities, and securities of all kinds.

Q. Has it been your duty to place values upon them from time to time? A. Yes.

Q. You have bought and sold, of course, many stocks and bonds, haven't you? [351]

A. Yes, sir.

Q. You were here and heard Mr. Lovelace testify, did you? A. Yes, sir.

Q. Particularly with respect to the general mar-

(Testimony of Lyman R. McFie.)

ket condition on June 5, 1941, or about that time?

A. Yes, sir.

Q. Would your testimony be substantially the same as his with respect to general conditions?

A. Yes, it would.

Q. Have you made an examination—I will withdraw that. Have you been furnished with a copy of the stipulation that has been presented here in evidence together with the exhibits?

A. Yes, sir.

Q. Have you made an analysis of those exhibits and stipulation?

A. Yes, sir.

Q. Have you formed an opinion as to the fair market value on June 5, 1941, of 200 shares of stock of the Carson Estate Company?

A. Yes, sir.

Q. Have you formed an opinion as to the fair market value of that same date of 100 shares of the Dominguez Estate Company?

A. Yes, sir. [352]

Q. And have you also formed an opinion as to the fair market value on that date of 500 shares of the Francis Land Company stock?

A. Yes, sir.

Q. Mr. McFie, you are acquainted in a general way with these various companies, are you not?

A. Yes, sir.

Q. They have been in existence a long time, haven't they?

A. Yes, sir.

Q. You are also familiar in a general way with their holdings?

A. Yes, sir.

(Testimony of Lyman R. McFie.)

Q. Their real estate holdings and their oil properties?

A. Not so much the real estate holdings.

Q. But you do know the real estate is located here in Southern California, and much of it in Los Angeles?

A. Yes.

Q. What basis did you use in determining the fair market value of the 200 shares of the Carson Estate Company stock, Mr. McFie?

A. I took the stipulated value and took the value of the oil royalties that were furnished by Mr. Paul Paine and divided them back into the Carson Estate Company.

Q. I think probably—— [353]

Mr. Melville: I don't want you to lead the witness.

Mr. Mackay: I am not leading the witness.

The Court: There is nothing to rule upon. You may proceed.

Mr. Mackay: I will withdraw that right now.

By Mr. Mackay:

Q. I would like to ask you—I think it would be better to go the other way—I will ask you what your basis was for determining the fair market value on June 5, 1941, of the 100 shares of the Dominguez Estate Company stock?

A. I used the stipulated value——

Q. You mean the value stipulated on the balance sheets, on the exhibits?

A. Yes. —for all properties other than the oil royalties. I used Mr. Paul Paine's estimate of \$3,-

(Testimony of Lyman R. McFie.)

000,000.00 as being the value of the oil royalties on that date.

Q. Why did you use Mr. Paul Jaine's figure?

A. Because I regard Mr. Paine, probably with Mr. de Golyer, as the two outstanding petroleum engineers in the United States.

Q. Has your company had occasion to use Mr. Paine from time to time?

A. No, we have never used Mr. Paine. We have never had occasion to use any petroleum engineers, but I have talked to a great many people who have used him.

Q. All right. Now, proceed. [354]

A. The stipulated value of Dominguez properties, excluding the royalty oil, was \$470.30.

The Court: Per share?

The Witness: Per share. Dividing the \$3,000,000.00 appraised value set on the oil royalties by Mr. Paine by the number of shares outstanding gave a figure of \$285.70.

By Mr. Mackay:

Q. Per share?

A. Per share, or a total appraised and stipulated value of \$760.00 per share on June 5, 1941.

The Standard Oil Company of California had a book value as of 12-31-41 of \$44.66 per share. The last sale on the New York Stock Exchange on June 5, 1941, was \$20.50. In other words, it sold at 45.9 per cent of its book value.

Union Oil on the same date had a book value of \$30.11, and the closing sale on the New York Stock

(Testimony of Lyman R. McFie.)

Exchange was \$13.75, so that it sold at 45.68 per cent of its book value.

These are both integrated companies, very aggressive and progressive. I could not certainly give a small, call it family or personal holding company, with their oil holdings in one field, incidentally situated right along one of our major earthquake fault lines in Southern California, and I have been told by an operator that damage has been done by earthquakes in that field—I could not give that company the same ratio to its appraised or stipulated value as I could companies of [355] the caliber of Union or Standard Oil Company, both listed on the New York, San Francisco and Los Angeles Stock Exchanges with a ready market at all times, with the stock held in practically every state in the Union and probably in every country in the world, so I took an arbitrary figure of 40 per cent of the \$760.00 per share, which set a value of \$304.00 per share on the Dominguez stock.

Q. Now, is that your opinion as to the fair market value of that stock on that date?

A. Yes, sir.

The Court: What was the figure again?

The Witness: \$304.00. That is 60 per cent discount from the \$760.00. I did not both with the few odd cents in there.

Taking that figure and dividing it back, taking the \$760.00 a share which was the stipulated and appraised value of Dominguez stock, dividing that back into the Francis Land ownership of 5,499

(Testimony of Lyman R. McFie.)

shares, it gave Francis Land Company an appraised and stipulated value of \$836.00 per share. Again taking a 60 per cent discount, it brought the value, in my opinion, on that date at \$334.40.

By Mr. Mackay:

Q. That is for Francis Land Company stock?

A. Francis Land Company. Now, taking the stipulated values and the appraisal of Mr. Paine on the Carson holdings, they owned 1,353 shares of Dominguez, and they owned 1,785 shares [356] of Francis, which in turn owned 5,499 shares of Dominguez, so that their proportionate holdings of the Dominguez stock owned by Francis figured at 1963.14 shares, so that directly and indirectly Carson owned 3,316.14 shares of Dominguez. The stipulated value per share of Carson, excluding oil royalties, was \$103.00 per share. Using the stipulated value of Dominguez properties, excluding the oil royalties, of \$474.30 per share, and multiplying and dividing it out, it gave Carson Estate Company a value of \$212.00 per share. When I say value, I mean appraised and stipulated. The Carson Estate Company, according to Mr. Paul Paine's appraisal of their oil royalties of \$283,000.00, was equivalent to \$38.00 per share, and the Carson Estate Company share of Dominguez Estate's oil royalties appraised by Mr. Paine at \$3,000,000.00 figured out \$127.00 per share, which gave the Carson Estate Company an appraised and stipulated value of \$480.00 per share. I took a 60 per cent discount,

(Testimony of Lyman R. McFie.)

which gave me a value of \$192.00 per share as the fair market value on June 5, 1941.

Q. Will you explain to the Court how you arrived at that 60 per cent discount in each one of those cases?

A. It is an arbitrary figure. I can conceive in my mind of stock in a family holding company, as I said before, with their oil properties located in one field, a company that is liquidating its resources, setting up no surplus but paying out more than they are earning, and I could not conscientiously [357] base that the same as I would Standard of California or Union of California, and, as I told you first, they were both selling at about $45\frac{3}{4}$ per cent of their book value.

Q. What consideration did you give to the earnings as shown in these stipulations?

A. If it had not been for the possibility of a fairly short pay-out, I will put it, rather than earnings, I would have reduced that from 60 to probably $66\frac{2}{3}$ per cent. For a person to buy this, in my opinion, to buy stock in Dominguez, Carson, or Francis, it simply is a guess as to how soon you get paid back. After you get it back your profit is in there.

Mr. Mackay: You may take the witness.

Cross-Examination

By Mr. Melville:

Q. Do I understand your testimony to be that

(Testimony of Lyman R. McFie.)

after arriving at the percentage—I will withdraw that question.

Tell the Court how you arrived at the 40 per cent, to begin with?

A. I did not and do not believe that the stock in the Dominguez Estate Company is worth as much or was worth as much on that date as stock in Union Oil Company of California or Standard Oil Company of California.

Q. And you took into consideration certain factors with respect to the Union Oil Company and the Standard Oil Company in arriving at a percentage, is that correct? [358]

A. I took the prices at which those stocks closed on June 5, 1941, and took the percentage of that market price to their book value.

Q. Book value of what? Their assets?

A. Their book value, all of their assets.

Q. Fine. Did you consider any other companies besides those two in arriving at or making this comparison to get a percentage?

A. Yes, I have a great quantity of figures. I left them at the office because Mr. Lovelace has furnished very much the same line that I would and I did not want to take up the time of the Court.

Q. That is all right, Mr. McFie.

A. I have here Atlantic Refining Company on that date, and at 12-31-41, it had a book value of \$63.66.

Q. When you say book value, you mean book value of its assets?

A. That is what book value is. It closed on the

(Testimony of Lyman R. McFie.)

New York Stock Exchange on that date at \$20.00, so that the last sales price was 31.2 per cent of its book value. U. S. Steel on that date sold at 47.7 per cent of its book value. Western Union sold at 12.7 per cent of its book value.

Q. I believe we can cut this short.

A. All right.

Q. In other words, you went right down a long list and [359] on the basis of all the companies that you studied, you made a comparison of the closing prices of their stock in the Exchange as of—what was the date? A. June 5, 1941.

Q. And you compared that with the book value of their assets as of what date? A. 12-31-41.

The Court: 1940, I suppose you mean.

By Mr. Melville:

Q. Did you mean 1940 or 1941?

A. My figure here shows 1941. It must have been 1940. These were taken from Standard Statistics, and the difference would be very minor, maybe \$1.00 or \$2.00 per share one way or the other, I think.

Q. But you don't know whether it was 1940 or 1941? Your figures you are reading from show 1941? A. They show 1941, yes.

Q. In considering all of these companies, now, you compared the selling price on the New York Stock Exchange, taking the close, and compared it with the book value of their assets as of December 31, 1941, and arrived at a percentage, averaged

(Testimony of Lyman R. McFie.)

them up, and you arrived at a percentage of 40, is that correct?

A. No, I took individual per cents. I did not average them. I took them individually as stocks. I also took into [360] consideration their dividends and their earnings.

Q. Just how did you get this figure of 40 per cent? Didn't you testify on direct examination that you took the prices at which the stock of Union Oil Company and the stock of Standard Oil—is that California? A. That is right.

Q. —sold on June 5, 1941, and compared that with the book value of the assets of those companies and you got a percentage in each case, and the average of those percentages was 40 per cent?

A. No. The two that I specifically paid attention to were Standard of California and Union of California, which, as I told you, was 45.9 in the case of Standard of California, and 45.68 in the case of Union of California. In my opinion there is no comparison between the stocks of Francis, Carson, or Dominguez to the stocks of Standard or Union of California, and if a customer came in my office and asked to purchase some oil stocks or royalty stocks, I would definitely have recommended that they buy Standard of California and Union of California rather than Dominguez, Francis, or Carson, even at the discount that I have taken.

Q. Now, you arrived first at a discount of 40 per cent? A. 60 per cent discount.

Q. Doesn't your testimony on direct examina-

(Testimony of Lyman R. McFie.)

tion after you get through talking about Union and Standard give a discount [361] factor of 40 per cent?

A. In the case of Dominguez, for instance?

Q. No, for these companies that you studied.

A. No, I gave a discount of practically 55 per cent. That is what they were selling at, 55 per cent off their book value, or 45 per cent plus a fraction of their book value. In other words, they were selling—we will cut out the fractions by way of explanation, and they were selling at a discount of 55 per cent from their book value or they were selling at 45 per cent of their book value.

Q. I am referring now to the work sheet that you have before you, and I call your attention to a list of percentages which starts off with Standard Oil at 45.9; Union Oil, 45.68; Atlantic Refining, 31.2; U. S. Steel, 47.7, and so forth. When you got all through did you add those and take an average of them? A. No, sir.

Q. You did not testify, then, as to any 40 per cent discount in this case either with respect to these companies or with respect to the Dominguez Estate Company?

A. If I did, it was a slip of the tongue. The discount in the case of these companies, Standard and Union, is roughly 55 per cent. In the case of Dominguez, Francis, and Carson, it was 60 per cent.

Q. All right. [362]

(Testimony of Lyman R. McFie.)

A. In other words, they sold at 40 per cent or 45 per cent of their book value.

Q. They sold at 40——

A. 45 per cent of their book value.

Q. I guess that is probably what I had in mind.

A. You got the per cent rather than the discount.

Q. All right. If these companies that you analyzed sold at 40 or 45 per cent of their book value, then the discount would necessarily be 60 or 55 per cent from their book value——

A. That is right.

Q. ——to arrive at the sales price?

A. That is right.

Q. Now, did you read from that, then, that since Dominguez Estate Company stock is worth not as much, being a closely held family corporation——

A. With one market.

Q. With one market. ——it is not worth as much as these stocks, and therefore instead of taking as in these stocks a discount of 55 or 60, you took the maximum of 60, is that correct?

A. That is right.

Q. And off of what figure, then, did you take the 60 per cent? The book value?

A. Off of the appraised and stipulated value, which I [363] am saying for intents and purposes is——

Q. The same as book?

A. No, I think book value would be higher, and in the case of the Standard and Union of Califor-

(Testimony of Lyman R. McFie.)

nia, I would say that book value is very much lower.

Q. What about the book value and appraised value in our case?

A. You have stipulated a value on everything except the oil royalties, and I am relying upon Mr. Paine's judgment——

Q. As to them?

A. ——and appraisal as to the value of those.

Q. What is the total figure that you applied your 60 per cent to in arriving at your estimate or opinion of the fair market value of Dominguez Estate Company stock?

A. I took a discount of 60 per cent from an appraised and stipulated value of \$760.00 per share.

Q. Where did you get your \$760.00 per share?

A. I gave that in direct examination, but I will give it again. The per share value of Dominguez, excluding oil royalties, is stipulated at \$474.30.

Q. How did you arrive at that? Go back to that, please.

A. It was furnished to me by Mr. Mackay.

Q. Did he furnish you——

The Court: What is that? Is that the sum of those items shown there on Exhibit 1-A divided by the number of shares [364] of stock? Is that correct?

The Witness: I believe that is right.

By Mr. Melville:

Q. Which column?

The Court: The last column of 1-A?

(Testimony of Lyman R. McFie.)

The Witness: I haven't 1-A before me.

The Court: This is it here (indicating). Is this what you did, add these four?

The Witness: No, I was given the figure.

By Mr. Melville:

Q. You were given the figure? Have you ever seen this exhibit or a copy of it? A. Yes, sir.

Q. If these figures were added up and divided by the number of shares outstanding, it would give you the figure down here that you used?

A. I think so, yes, sir.

Q. Why didn't you use the book value figures?

A. Because I could not rely upon the book value figures on Dominguez as well as I could the book value figures of Standard and Union. I don't know how Dominguez kept their books except by looking over the manner in which they took depletion. I was satisfied that their books were not on the same basis that Standard and Union would keep their books. An appraisal, in my opinion, of Standard or Union would show a [365] very much greater value than these book values which I have used.

Q. Whose appraisals and for what purpose?

A. Well, it is a tremendous job to appraise, but I do know of some of the properties that they have bought in which they have not capitalized, according to some of the officers of the company.

Q. In considering these various companies, now, Mr. McFie, you don't have any knowledge or even an opinion as to the fair market value of their assets, do you? A. No, sir.

(Testimony of Lyman R. McFie.)

Q. You took their book value?

A. Which companies are you referring to?

Q. These on your work sheet.

A. Will you repeat that question?

(The question was read)

Q. I might clarify that for you.

A. By "these companies" you mean——

Q. Standard Oil and right down the list, not the Dominguez Company or the Carson Estate Company or the Francis Land Company, but the other companies that you considered and with which you make comparisons.

A. I know what the market value is.

Q. Market value of what?

A. Of Standard, Union, Atlantic Refining, et cetera. [366]

Q. The market value of their stock?

A. That is right.

Q. But you don't know the fair market value of their assets? A. No.

Q. And, therefore, you used the book value?

A. That is right because I——

Q. In our case you have both the book value and the agreed fair market value before you, but you chose to take your 60 per cent discount from the agreed fair market value, isn't that right?

A. The stipulated——

Q. Isn't that right?

A. I will have to explain.

Q. Answer the question yes or no and then explain. A. Yes.

(Testimony of Lyman R. McFie.)

Q. That is right? A. That is right.

Q. Now, you may explain.

A. The book value of these different companies, Carson, Dominguez, and Francis, was greater than the stipulated modern, up-to-date appraised value according to the figures furnished me. The manner of taking their depletion was such that I do not believe their book value reflects a fair value. As a matter of fact, your stipulated values in all cases were considerably [367] less than their book values. In the cases of Standard and Union, I know that their intrinsic value of fair market value of assets would be greater.

Q. It is stipulated, Mr. McFie, that the book value of Dominguez Estate Company's assets, not counting oil properties, was on May 31, 1941 \$9,803,763.11—I can correct it—\$9,564,346.61. That does not include anything for oil properties. If you add \$3,000,000.00, which is the appraised figure that Mr. Paine furnished you to that, you will have \$12,564,346.61. Why wouldn't it be fair to take 60 per cent of that rather than 60 per cent of our stipulated fair market value figures?

A. Because I don't think the book values were anything like being correct.

Q. Did you inquire into the correctness of the book values of the Standard Oil Company and the Union Oil Company, and so forth?

A. I made a tentative offer for the Union Oil Company of \$35.00 a share and was laughed at. I have been told by officers of the company and I

(Testimony of Lyman R. McFie.)

have been told by petroleum engineers that they considered the book values of both companies were very low.

Q. You are basing your opinion, then, on hearsay?

A. And definite information. Standard of California, for instance, are carrying their foreign holdings at cost less depreciation. They have not given any reflection whatever to [368] the discovery in Saudi Arabia. They own a half interest there of 47 outlying structures, producing from five, and so far have not gone far enough in the five to be able to engineer the reserves, and I have been told by the vice-president of the Standard Oil Company of California, and likewise the Texas Corporation, who own the properties jointly, that the first structure has a reserve of 1,000,000,000.00 barrels, the second one 5,000,000,000.00 barrels, and that is not reflected in their book value of \$44.66.

Q. Did you value the Francis Land Company stock and the Carson Estate Company stock in the same way that you valued the stock of Dominguez?

A. Yes, sir.

Q. You know, don't you, that there are a number of oil royalty companies in California?

A. I imagine there are.

Q. But you did not consider them in making your comparison?

A. We do not sell oil royalties. Our firm does not permit it except as an agent. When a customer desires to buy oil royalties through us, we have them

(Testimony of Lyman R. McFie.)

sign a statement to the effect that it was unsolicited.

Q. But aren't there oil royalty companies in California which have stocks that are traded on the market?

A. I don't know anything about that, sir. [369]

Q. You don't know that? A. No, sir.

Q. Then you did not consider such companies in making your comparison. A. No, sir.

Mr. Melville: That is all.

(Witness excused.)

The Court: Very well, we will suspend until 2:00 o'clock.

(Whereupon, at 12:30 o'clock p. m., a recess was taken until 2:00 o'clock p. m., of the same day). [370]

Afternoon Session. 2:00 p. m.

Mr. Mackay: Call Mr. McCuen.

C. MELVIN McCUEN,

called as a witness for and on behalf of the Petitioner, having been first duly sworn, was examined and testified as follows:

Direct Examination

The Clerk: Will you state your name for the record, please?

The Witness: C. Melvin McCuen.

By Mr. Mackay:

Q. What is your address, Mr. McCuen?

(Testimony of C. Melvin McCuen.)

A. 621 South Spring Street.

Q. How long have you practiced as an investment counsel in Los Angeles? A. 14 years.

Q. How long have you engaged continuously and exclusively in analyzing securities for investment purposes? A. Since 1923.

Q. How many clients do you serve on a fixed fee annual basis? A. 32.

Q. Approximately how much capital do you manage or supervise? [371]

A. Approximately \$9,000,000.00.

Q. In how many cases have you appeared as an expert witness before the Tax Court?

A. In five.

Q. Have you determined the fair market value of the Dominguez Estate as of June 5, 1941?

A. I have, sir.

Q. What is your opinion as to the fair market value of the stock of the Dominguez Estate Company on June 5, 1941, particularly the 200 shares that are in question here?

Mr. Melville: I object, your Honor. Just a minute, Mr. Mackay. I would like to ask a few questions preparatory to a possible objection.

Mr. Mackay: All right.

Mr. Melville: Mr. McCuen, have you ever had any experience in valuing oil royalties.

The Witness: Not specifically oil royalties.

Mr. Mackay: I should have laid a better foundation for that with Mr. McCuen.

(Testimony of C. Melvin McCuen.)

Mr. Melville: Do you want to proceed again?

Mr. Mackay: Yes.

By Mr. Mackay:

Q. Have you been furnished, Mr. McCuen, with a copy of the stipulation that has been filed in court here? A. I have. [372]

Q. And also the exhibits attached thereto?

A. Yes.

Q. And have you made an analysis of those exhibits? A. I have, sir.

Q. And you have formed an opinion based upon the information therein contained, together with your background or experience, have you?

A. Yes.

Q. Now, those exhibits, I think, stipulate the fair market value of all the assets of the Dominguez Estate Company except the oil royalty interests. What figure do you use there, Mr. McCuen.

A. In the computation on the fair market value of the oil royalty assets I have used the estimate of value of the appraisal by Mr. Paul Paine.

Q. And why did you use that?

A. Well, I was for six years the statistician and analyst for Dean, Witter Corporation, and from my knowledge of his general reputation and standing for integrity and ability and success, I feel very safe and confident in accepting his valuation. Of course, I also checked his valuation against other evidence that seemed to indicate that that was a very reasonable and sound valuation.

Q. What did you check with?

(Testimony of C. Melvin McCuen.)

A. Well, at that time the oil assets of leading producing [373] companies in California and the United States sold for about 35 to 40 cents per barrel. Some oil companies, such as Superior Oil Company, sold as low as 18 cents per barrel. If you take about 35 or 40 cents per barrel for the estimated number of barrels that were in the Dominguez Estate here, you will arrive at a value of around \$3,000,000.00.

Q. \$3,000,000.00? A. Yes, sir.

Q. Now, will you please tell the Court how you arrived at the fair market value of \$380.00 per share for the Dominguez Estate Company on June 5, 1941?

Mr. Melville: I am sorry, but I did not know he testified to that.

By Mr. Mackay:

Q. Didn't you? I beg your pardon.

Mr. Melville: I move that it be stricken.

The Court: He has not stated what he thought the value was.

By Mr. Mackay:

Q. What, in your opinion, was the fair market value?

Mr. Melville: I object.

The Court: Wait a moment. We are all talking at once. The reporter cannot get it. Have you completed your question, Mr. Mackay?

Mr. Mackay: No, your Honor. [374]

The Court: You may proceed with the question.

By Mr. Mackay:

Q. What, in your opinion, was the fair market

(Testimony of C. Melvin McCuen.)

value on June 5, 1941, of the 200 shares of capital stock of the Dominguez Estate Company?

Mr. Melville: I object, your Honor.

Mr. Mackay: I beg pardon. 100 shares.

The Court: Just a minute before the witness answers. What is your objection?

Mr. Melville: My objection, your Honor, is based on the fact that the witness has testified that he is basing his opinion in part on the opinion of Mr. Paine and he is not qualified himself to form an independent opinion as to the fair market value of the oil royalties, and they must be taken into consideration in making any estimate of the value of the stock of the Dominguez Estate Company.

The Court: Well, the witness has testified that he used the figure which Mr. Paine had supplied and that he himself checked that figure with some other oil companies or records that he had.

Mr. Melville: I believe your Honor will recall, though, that he also testified that he has had no experience in valuing oil royalties.

The Court: Well, your objection goes more to the weight, I think, to be given to the testimony. We will permit [375] him to answer the question which has now been asked.

A. In my opinion, the fair market value of the Dominguez Estate Company on June 5, 1941, was \$380.00 per share.

By Mr. Mackay:

Q. Will you please tell the Court how you arrived at that value?

(Testimony of C. Melvin McCuen.)

A. Well, I, of course, carefully studied the income statements and balance sheets for ten years back and I studied carefully the stipulated value between the Petitioner and the Respondent, and, as I stated, I accepted the estimated appraised value of the oil royalty assets by Mr. Paul Paine at \$3,000,000.00, and that gave a total asset value of \$7,979,700. Now, this value of \$380.00 I tested against the assets and the earnings of the Dominguez Estate in the light of the distributions made and the limited market of the shares of this personal holding company. I have also tested this value in relation to the prevailing price of capital as of June 5, 1941, and after comparison with the market prices of oil and other shares prevailing in Los Angeles as of the basic date. Now, I think the price of capital is a very important consideration because the fair market value of any type or character of security is regulated by the price of capital. Some investors weight this economic factor more carefully than do others, but all consider the relative earnings and the prevailing return on invested capital, and investors seek the employment of capital in that market which offers the greatest income consistent with the demands of the investor with respect to safety, type and character.

Now, what was the price of capital on June 5, 1941? On this date we find the following yields on the various types of fixed income securities: Long-term Government Bonds yielded 2.3 per cent; highest grade long-term corporate bonds, 3 per cent;

(Testimony of C. Melvin McCuen.)

good grade corporation bonds, 3.6 per cent; highest grade corporate preferred stocks, 4 per cent; and good grade corporation preferred stocks, 4.75. The long-term interest rate is not only the foundation for the price structure of all long-term fixed income investments, that is, bonds and preferred stocks, but it is also the basic starting point in the analysis of valuation on equities or common stocks. However, in the case of common stocks, the analyst must deal with earnings as well as with the dividend yield. I think the prospective willing buyer and seller would have considered the earnings of the year 1940 more representative of the probable immediate future years' earnings than any other year or series of years of the past. The earnings of the Dominguez Estate Company in 1940 of \$47.27 compares with the average of \$51.35 for the ten years ended in 1940. The trend of earnings was down. The 1940 earnings were slightly less than one-half of those reported in 1936, and the earnings for the full year of 1941 of \$47.91 were indicated by the results of the first five months [377] of 1941. Furthermore, the earnings for 1940 of \$496,282.00, or \$47.27 per share, appear to be the most probable future earnings in relation to the estimated production and earnings curve for the major life of the royalties.

I asked myself how much these earnings were worth. In my opinion they were not worth more than 12½ per cent, capitalization basis, that is to say, 8 times earnings, and those earnings of

(Testimony of C. Melvin McCuen.)

\$496,282.00 were before any real deduction for depletion.

Now, on June 5, 1941, the 30 Dow Jones Industrial stocks, the best known American stock averages, and I have chosen that because it was taken without hindsight information, it was an average which had been computed and available and it was the barometer of general common stock values prevailing at that time—this was at 118.13 in relation to the 11.68 earned per composite share in 1940, or the Dow average sold for approximately 10 times 1940 earnings, and it also sold for 11.8 times the five-year average earnings for the period ended in 1940.

The three oil companies used in this industrial composite, that is, the Standard Oil of California, the Standard Oil Company of New Jersey, and the Texas Company, were also selling for 10 times their average five-year earnings for the period ended in 1940.

Of course, the earnings of the 30 industrial corporations [378] used in the Dow-Jones Industrial average were after deduction of depreciation and depletion. In using and multiplying 8 times earnings for the Dominguez Estate Company before depletion I am actually appraising these earnings at more than 10 times after what would have been considered a normal depletion for that corporation. I feel reasonably sure in stating that I do not believe anyone would have appraised the common stock risk of the Dominguez Estate Company on

(Testimony of C. Melvin McCuen.)

June 5, 1941, at a higher price than he would have valued the composite of the 30 Dow-Jones Industrials which are higher grade investments, or the 3 stocks used in the Dow-Jones Industrial average.

Furthermore, the shares of 14 well-known, actively dealt in, oil producing corporations in the California markets were selling for 7 times the 1941 earnings before depletion. Such a list contains Amerad, Barnesdale, Kern County Lands, Superior Oil.

Now, 8 times \$47.27 per share for the Dominguez Estate Company is equal to \$378.16. As I testified earlier, in my report, I found the asset value to be \$760.04. However, these assets as per the stipulated values and the appraised value of Mr. Paul Paine were not producing earnings to support a market value of \$760.00 per share. Inasmuch as the problem, as I see it, in this case, is to value the shares of a minority interest which has no power to liquidate the assets, it is my [379] opinion that the market value of this stock is best tested against the probable earnings of the future rather than against the asset value, because where no liquidation is indicated, the stockholder or prospective stockholder is more interested in the earning power of the business than in buying at asset position. It is interesting to note that at June 5, 1941, the two major California oil companies sold for less than one-half of the December 31, 1940, book value, that is, the Standard Oil of California and the Union Oil sold for about 46 per cent of their book

(Testimony of C. Melvin McCuen.)

value assets. Not only were oil assets depressed in the Los Angeles market on June 5, 1941, but assets of our leading banks sold for very substantial discounts. The market price and book values of two of the large local banks, in splendid financial condition, were as follows: Citizens National Trust and Savings had a book value of 41, and it sold for 24 or 59 per cent of its book value, which was composed largely of Government Bonds and a real estate asset which has been written far down. The California Bank at a book value of \$46.00 per share, and a market price on June 5, 1941, was \$25.00, so it sold for 54 per cent of its book value.

In the light of the prevailing discounts in relation to book value at which our leading oil, industrial, utility, and bank shares sold on June 5, 1941, I doubt if the assets of the Dominguez Estate would have sold for more than 50 per [380] cent of the stipulated and estimated book value, for \$380.00 per share. The ranch and real estate assets were a drag on the earnings because the expenses of servicing these assets exceeded their income. The market on June 5, 1941, discounted the net working capital and investments of our leading companies.

Furthermore, it would have been logical to assume that the willing buyer and willing seller would have bought and sold the shares of this stock on the basis of book value. I have continually kept in mind the liquidating nature of the business of the Dominguez Estate Company, and therefore have taken into full account the distributions and

(Testimony of C. Melvin McCuen.)

dividends of \$72.00 paid in 1940. Of course, such distributions were far in excess of the earnings of \$47.00 and odd cents. Such distribution represented not only a return on investments, but also a return of capital.

Marketability is so essential a factor, and so importantly so in the fair market value of shares of common stock, that it cannot be ignored but should be fully reckoned with in computing the fair market value of any share of common stock. It is my opinion that of two given securities assumed to be identical in every respect other than marketability, if one possesses no marketability at all and the other a high degree of marketability, the latter security will enjoy a market value of at least 15 per cent or more higher than [381] the fair market value of the former.

So, after considering the earnings as reported and the assets as per the stipulated value and distributions and the marketability, I think that a fair price that both would have agreed upon, that is, the buyer and the seller, the prospective buyer and seller, would have been \$380.00 per share.

Q. Mr. McCuen, I think you mentioned the Standard Oil and Union Oil of California. Did your analysis of either one of those companies' statements disclose any estimated oil reserves?

A. Well, the estimated oil reserves of the Union Oil at the end of 1940 are figured at 300,000,000 barrels. Now, the market price of Union Oil on

(Testimony of C. Melvin McCuen.)

June 5, 1941, was, I think, \$64,161,000.00, and they had——

Q. Did you say \$63,000,000.00?

A. \$64,161,000.00.

Q. I see.

A. They had net working capital of excellent composition and their investments and buildings, less the debt on those buildings, were \$63,172,000.00. In other words, all the 300,000,000 barrels of oil in the ground from this conception of value you could have gotten for nothing. All you were paying for in buying the Union Oil Company as of this date was for the assets above the ground.

Q. Now, Mr. McCuen, have you also formed an opinion as [382] to the fair market value of the Francis Land Company shares at June 5, 1941, and particularly the 100 shares in dispute?

A. I have, sir.

Q. What is your opinion as to the fair market value of that?

A. In my opinion the fair market value of the Francis Land Company was \$375.80 per share.

Q. How do you arrive at that?

A. Well, there was a little different approach to the estimation of the fair market value of the Francis Land Company as compared with the Dominguez Estate Company in that the Francis Land Company is essentially a holding company. It held practically 1.1 shares of Dominguez Estate common stock for each share of common stock that it had outstanding, and it had no other substantial

(Testimony of C. Melvin McCuen.)

assets, and of the other assets it had, their total value was exceeded by the total current liabilities of the company.

Now, I believe as a holding company that the shares of that stock would have been discounted by at least ten per cent. In other words, taking the estimated value of \$380.00 per share for the Dominguez Estate, you get a valuation of \$417.55 per share for the Francis Land Company, but I do not believe the buyer would have bought nor the seller would have demanded the full indicated book value as per that appraisal on the Dominguez because the Francis Land Company was subject [383] to taxes, and the Dominguez stock in the Francis Land Company was further removed from the stockholder than if he had bought the Dominguez Estate Company stock outright. Therefore, I subjected it to a nominal discount of 10 per cent. I am reasonably sure that it would have been at least 10 per cent, and it may have been higher.

Q. Have you also formed an opinion as to the fair market value of the stock of the Carson Estate Company, the 200 shares given away on June 5, 1941? A. I have, sir.

Q. What is your opinion as to that?

A. In my opinion the fair market value of the Carson Estate Company as per the stipulated values, and taking the Francis Land Company stock at \$375.80, produces a total value of \$2,231,340.00 for the Carson Estate Company. When you divide that by 7,412 shares of common stock

(Testimony of C. Melvin McCuen.)

outstanding, you get a book value as per those stipulated and estimated values of \$301.00 per share, and I deducted 20 per cent from that value and arrived at a fair market value of the stock of the Carson Estate Company of \$240.80. The Carson Estate Company, while it had other assets than the Dominguez Estate stock and the Francis Land Company, those assets were not particularly productive, and I think—in fact, their expenses exceeded their income—and I think that would have been viewed as any investment trust share or any holding company stock. Now, on [384] June 5, 1941, I find such splendid holding company stocks, that I think had far better underlying assets in them, as Christiana Securities. That is the top holding company that controls the General Motors and the DuPont Company. Now, the book value of that stock on December 31, 1940, was \$3,263.00. It sold for \$2,360.00, or at a discount of 27.7 per cent. Lehman Corporation had a book value on December 31, 1940, of \$29.64, and its market value on the New York Stock Exchange on June 5, 1941, was \$20.75. The discount from book value was 29.3 per cent.

The Security Company, a well-known holding company listed but not so actively traded on the Los Angeles Stock Exchange, but there is always a bid and offering price not so far apart, had a book value of \$40.36, and it sold for \$30.00, or the reasonable spread between the bid and asked would

(Testimony of C. Melvin McCuen.)

have been \$30.00, and that therefore sold at a 38 per cent discount.

It should be evident that the fair market value of any investment or holding company share of stock is not necessarily the equal of the net assets or book value of the assets divided by the total number of shares. Such companies have to pay income taxes and are subject to management and administrative expenses that detract from the underlying value of the assets.

So, I think, in view of the discounts that such splendid investment or holding company stocks sold at, that [385] a discount factor of at least 20 per cent would have been agreed to by both the willing buyer and the willing seller of the Carson Estate Company as of the basic date.

Q. I think you mentioned—I want to make sure—in considering the asset value there—I will withdraw that.

In forming your opinion as to the fair market value of the Carson Estate Company stock, you did accept a certain value for the oil royalties? That is right? A. Well, I——

Mr. Melville: I object. That is leading.

Mr. Mackay: I think it is.

The Court: The objection will be overruled.

The Witness: I accepted your stipulated value of the Petitioner and Respondent of \$285,000.00.

Mr. Mackay: O. K. That is all. You may take the witness.

(Testimony of C. Melvin McCuen.)

Cross Examination

By Mr. Melville:

Q. Mr. McCuen, you stated that in valuing the stock of a personal holding company you took into consideration the fact that that personal holding company has income taxes and administration expenses and therefore the value of its stock must be somewhat less than the proportionate part of the assets? Is that your view?

A. No, I don't think—are you referring to when I [386] valued the Francis Land Company?

Q. It was toward the past part of your testimony. You said you took income taxes and administration expense into account. Now, please tell us about that?

A. Oh, yes. Well, you see, for instance, if you buy a group of corporation stocks listed on the New York Stock Exchange and you form a corporation and hold those, you will have to pay administrative and management expenses of the holding corporation there, and, of course, that detracts from the value of the underlying assets of that holding corporation.

Q. Now, Mr. McCuen, if you had \$500,000.00 and you were wondering in your own mind whether you would be better off to form a personal holding company, and after giving it some thought you decided to form a personal holding company and issued 5,000 shares of stock worth \$100.00 a share, you have this \$500,000.00 now invested in market-

(Testimony of C. Melvin McCuen.)

able securities and as of a given date your marketable securities are worth, let us say, \$500,000; what is the value of your stock per share?

A. The book value or the fair market value?

Q. The fair market value.

A. Well, of course, I don't know that I could answer that. I would want to know the corporation and its assets.

Q. It is your personal holding company. You know all about it. [387]

A. No, I do not, only the very few words you said about it. I would say that the book value would be, of course, \$100.00 per share as a going concern. If it was the intention to liquidate that corporation, you certainly would not get \$100.00 per share from that corporation from the assets if they had the value you indicated with the number of shares of common stock outstanding.

Q. Now, supposing I came to you and I said, "Now, I have got the money to invest and I think you know quite a bit about the securities market. You have got \$500,000.00 invested in marketable securities and I will bet my money that you made a good choice, that you have got your money pretty well spread"—diversification, I believe you call it—"so, rather than for me to go out and put my money in marketable securities, I would like to buy a few shares in your personal holding company." How much would you sell them to me for?

A. Well, if I were thinking of it from a selfish standpoint, I would naturally try to get as much

(Testimony of C. Melvin McCuen.)

as I could, but I would inform him that he could go out and buy common stocks of the very finest investment trusts or holding companies at about a 30 per cent discount. Then if he was willing to pay me \$100.00 for my stock as per the indicated book value, then of course he would have bought after being fully informed. It would probably have been worth that much to me if I owned all the stock and had the power of liquidating that corporation, but I do not think it would have been worth that much to the willing buyer because he could have gone out and bought other assets, unless I had particularly demonstrated myself that I could do very much better with those assets than the other investment trusts or holding companies were doing. Very few corporations do better than Lehman Brothers and Christiana Securities because DuPont and General Motors out-perform the averages.

Q. Let us get back to your personal holding company now. You tell me that you doubt very much that that stock would be worth \$100.00 a share to me? A. To the buyer.

Q. To me? I am the prospective buyer now. You are the one that owns the stock. You would be foolish to sell it to me for less than \$100.00, wouldn't you?

A. If I owned all of it and controlled the corporation it ostensibly would be worth \$100.00 a share to me.

Q. Would you or would you not sell me a share for less than \$100.00?

A. That is very difficult to answer.

(Testimony of C. Melvin McCuen.)

Q. I know I am making it difficult for you.

A. It is too hypothetical and it is not as specific as the problem we have here. We have all the facts of this case at hand and we have not all the facts of this other.

Q. But we are valuing a closely held corporation. Now, [389] there is nothing too difficult about the question I asked you. It seems to me that you should be able to answer my question yes or no. You either would or would not be willing to sell me 100 shares of——

A. I probably would not want to sell you the stock.

Q. All right. And you think that I would be foolish to pay you \$100.00?

A. I do if on the basic date you could have bought other leading investment trust shares at a 30 per cent discount, shares of proven merit and distinction in such companies as those which I have referred here.

Q. Now, when the willing buyer will only pay so much and the willing seller will not come down and they do not meet, there is no sale, is there?

A. That is right.

Q. So in this particular case you would be foolish, as I understand it, to sell me your stock for less than \$100.00, and, therefore, if I was willing, I would not buy it?

A. You would not pay \$100.00 for it if the same condition prevailed as on this basic date.

Q. Now, then, you decide to continue on owning

(Testimony of C. Melvin McCuen.)

the stock in this personal holding company; you have income taxes and administration expenses, do you? A. Yes.

Q. Now, the very fact that you continue this personal [390] holding company and pay these administration expenses and income taxes, doesn't that pretty well indicate that it was to your advantage to do so rather than to liquidate and take your money out?

A. It either was to my advantage or I had high hopes for the future enhancement of the value of those stocks.

Q. Oh, but you could still take the stocks out. This Dominguez Estate Company could distribute in kind, couldn't they?

A. Not as I understand it. We are evaluating a minority interest here who were powerless to do it. Of course, if I was called upon to evaluate a majority stock interest here, I assure you that I would have an entirely different answer than I have now.

Q. Let us go back, now, to the mathematics of arriving at your fair market value figure for the Dominguez Estate Company. You gave a figure of \$760.04. What was that?

A. That was the stipulated value of the net working capital, of the stocks and bonds, of the ranch and other real estate as per the stipulated value, plus the \$3,000,000.00 estimated value of the oil royalty by Mr. Paul Paine, making a total of \$7,979,700.00, and dividing that by 10,499 shares

(Testimony of C. Melvin McCuen.)

you get a book value of indicated fair market value from the asset standpoint of \$760.04. [391]

Q. Then I believe you took a discount from that? A. No, sir.

Q. Well, in the case of Francis you arrived at a—withdraw that question.

How did you go then? What was your next step after arriving at \$760.04?

A. I next tested the earnings to find what the value of the stock would be from the earnings standpoint. I believe the earnings standpoint for all going concern corporations generally should be accorded the greatest consideration, more than any other factor, that is, the factor of earnings, of assets, of dividends, or marketability. Those are the four cardinal factors in evaluating a common stock. I took the earnings of \$47.27 for 1940 because I believed that the year 1940 was the best norm year we could arrive at. If you multiply that by 8, and multiplying by 8 is equal to a capitalization ratio of $12\frac{1}{2}$ per cent, you will get a value of \$370.00, I think. To be exact, it is \$378.16.

Q. And from \$378.16 you made a round number of \$380.00?

A. No—somewhat, if you want to call it a round number. I thought, as I tried to demonstrate, that on June 5, 1941, very few corporations sold about the asset value because things were at a discount. I need not here rehearse the prevailing sentimental condition regarding world-wide military affairs and political considerations and tax considerations, and

(Testimony of C. Melvin McCuen.)

all of those. [392] It was an uncertain period. The stock market had already been on the drop from 1939 of around 156 to where it was down to 118, and there wasn't anything to indicate that the trend was going to stop at that time. So, assets sold at a discount, particularly here in L. A.

Q. All right. Then, did you discount the assets in this case?

A. I said, in view of the fact that our leading corporations, such as the Standard Oil of California and the Union Oil, the California Bank, and the Citizens Bank—that those assets sold on an average of about 50 cents on the dollar, and I don't believe anyone would have paid a higher price or ratio for these assets in the Dominguez Estate.

Q. If you take——

A. If you take 50 per cent of \$760.00, you get \$380.00 which bears out my earnings factor figures of \$378.16. So, instead of expressing it as \$378.16, I resolved it to a round figure of \$380.00.

Q. All right. Now, on Francis you followed the same procedure, as I understand it?

A. No. Francis was an entirely different——

Q. I think probably I should make that more explicit. In Francis, as I understand your testimony, you took what you estimated to be the fair market value of Dominguez stock and transplanted it into the balance sheet of Francis—— [393]

A. That is right.

Q. ——converted that into value per share of

(Testimony of C. Melvin McCuen.)

assets, and took a 10 per cent factor, and arrived at \$375.80? A. Yes, sir, that is correct.

Q. Then, in order to arrive at the value of Carson, you took the Dominguez stock at \$380.00, put that into the balance sheet, you took the Francis stock at \$375.80, and put that in the balance sheet, added them up, determined what the asset value per share was, and took a 20 per cent discount?

A. That is correct.

Q. Now, Mr. McCuen, that gives you in so far as the assets of the Carson Estate Company are concerned, a 50 per cent, which is what you took in Dominguez, and 10 per cent, which is what you took in Francis, plus a 20 per cent which you took in Carson. 50, 10 and 20 and 80 per cent that the assets of the Dominguez Estate Company are discounted by the time they are reflected in the fair market value of the Carson Estate Company? Isn't that your testimony?

A. It would appear that way but it is not exactly that simple, sir, for the reason that I did not value the Dominguez Estate Company primarily on its asset value. I took all the factors of valuation into consideration, that is, the earnings factor, the dividend factor, the marketability factor, and the asset factor. Now, if it happened to coincide with 50 per cent of the asset value, that is more of a coincidence of figures [394] than a method of valuation.

Q. Well, then, after having discounted the Francis assets at 10 per cent to arrive at the fair

(Testimony of C. Melvin McCuen.)

market value of Francis stock, why after you carry that stock into Carson Estate Company do you subject it to another 20 per cent discount?

A. Well, for the same reason that if you were to buy the stock of the Christiana Securities Company and the stock of the Lehman Corporation and the stock of the Security Company, or the stock of the State Street Investment Company, or any number of investment companies, and you want to form another corporation to hold those stocks, those stocks in my opinion would still sell at a further discount factor. Everyone does it. It is the method of a fair appraisal of such corporations.

Q. Now, in arriving at your—did you say in your direct examination that the earnings of the corporation were not sufficient to support the asset values that appear?

A. Yes, sir; definitely not.

Q. So, what did you do with the asset values?

A. Well, we weigh corporations, as I say, from the four points of view, and the earnings factor takes a predominating place. Frankly, I haven't any specific formula to say how much the earnings should weigh, how much assets should weigh, how much marketability should weigh, how much dividends should weigh. [395] They vary in such a number of degrees that we have to consider them all in the light of all the other facts and use our best judgment. That is the human approach to it.

Q. I hand you the stipulation which is in evidence, and on top is joint Exhibit 1-A, and I ask

(Testimony of C. Melvin McCuen.)

you what you think the asset value—what figure you used as to the asset value on ranch real estate?

A. I used the stipulated valuation. That was the value of those ranch real estates to the corporation as of that date.

Q. What figure was that?

A. \$1,629,950.00.

Q. In other words, you say that in making your comparison with other corporations you used the figures in this stipulated fair market value column?

A. I took those into consideration, sir.

Q. Did you take any other figures on this sheet into consideration?

A. Only to accept the \$3,000,000.00 of oil royalties.

Q. Substituting the \$3,000,000.00?

A. Yes.

Q. But those are all the figures on this sheet that you took into consideration in making your comparison with other companies?

A. In comparison with other companies, yes, that would be essentially so. [396]

Q. Now, in making your comparison with other companies, did you consider their asset value?

A. Yes, sir.

Q. What value did you use, the fair market value or the book value?

A. I used their book value, which was away under their earnings value, and, therefore, presumably below their fair market value.

Q. Purely a presumption on your part?

(Testimony of C. Melvin McCuen.)

A. It is a presumption based on many years of study and intense research.

Q. Did you have available to you the fair market value of the assets of the various companies that you considered in making your comparison?

A. No, none of those——

Q. If you had had them, would you have used them in preference to the book values?

A. In order to be fair with my comparisons, I would have had to, sir, definitely.

Q. In other words, the fact that you did not have them available justifies your not using them, but the fact that you did not use them was not exactly a fair comparison, was it?

A. I wouldn't say it is not a fair comparison. Of course, it is very difficult to compare any two corporations even when they look alike and in the same business, but book [397] value of assets and fair market value of assets—oh, I don't know, those are sometimes confusing terms. I do know that the evidence is very strong that the earnings of the Union Oil and the Standard Oil——

Q. Let us stay with assets now, Mr. McCuen. Is it your testimony that it would have been more fair in making your comparison to have used the fair market value of the assets of the other companies in comparison with the fair market value of the assets of the Dominguez, Francis, and Carson Companies?

A. I don't know that it would have been any more fair, but if I had had those fair market valua-

(Testimony of C. Melvin McCuen.)

tions of assets of those corporations, I would have used them although I would not have used the comparison.

Q. At all? A. That is right.

Q. Since you did not have the fair market value figures of the other companies to make the comparison but had their book value figures, and you had the book value figures in our companies, why didn't you use the book value figures in our companies and compare them with the book value figures in the other companies?

A. Well, because it is a well-known fact that the book value figures of the companies that I have used have been very fairly stated. Their earnings will prove the reality of those book values that I think would compare very favorably with the fair market value of those assets if on that date a miracle could have been performed and we had had all the fair market values of those corporations.

Q. Can you state in a few words why you did not make a comparison of like things with like things since you had them before you?

A. It is very difficult in closely held corporations to get comparisons with others. Even two well-integrated oil companies will differ in comparisons. It would be a most coincidental thing if you could find another corporation that in addition to having net working capital, stocks and bonds of another corporation, branch and real estate assets, which would also have oil royalties. But I don't think that that offsets or invalidates the value

(Testimony of C. Melvin McCuen.)

of the comparisons that I have made with these corporations because the Security Company had real estate assets, they had some ranch properties, they had a very excellent list of stocks and bonds, and they had working capital. They did not have any oil royalties. Well, if the assets of that company with known values sold at approximately a 40 per cent discount and were listed on the New York Stock Exchange, I don't think I was very far off in arriving at a value for the Dominguez Estate that was almost equal to 50 per cent of the assets, but that is only coincidental that my \$380.00 coincides with one-half of the assets.

Q. Do not oil royalties have the same relation to an [399] oil property that a bond does to the stock of a corporation?

A. Well, a bond of a corporation is, of course—if it is a contractual obligation, fixed in its terms, it occupies a prior position in the capital structure and earnings of that corporation. Now, an oil royalty has a fixed income if it is earned. It is more in the nature of an income bond, as I would compare it. If it is earned they pay it. If it is not, if the companies do not produce the oil, you do not get it and you cannot foreclose or do anything.

Q. Supposing the Shell Oil Company that is operating some of the leases in this case was operating at a loss, would the Dominguez Estate Company get their royalty?

A. If they kept the production up.

(Testimony of C. Melvin McCuen.)

Q. Supposing they only produced one barrel and they did so at a loss?

A. Well, I would assume that these people would get 1/6th of that barrel.

Q. So that even though the producing company operates at a loss and even though they produced one or a million barrels, the lessor, the Dominguez Estate Company, gets their share of all of the oil produced, don't they? A. Yes.

Q. So, to that extent isn't it very comparable to the bond of a corporation?

A. Well, I don't think I would make that comparison there. [400]

Q. It is a first lien, isn't it, on the property we are speaking about?

A. Well, I don't know. I am not trying not to answer it, but frankly I don't get the value of that comparison. I have an appreciation of oil royalties. You cannot live in California for nearly 30 years without knowing something about them, but how good they are when they are good and how, of course, bad they are when they are not good——

Mr. Melville: Your Honor, may we have a recess for a brief time?

The Court: Very well. We will suspend at this time for a brief recess.

(A short recess.)

The Court: Will there be any further examination of the witness?

(Testimony of C. Melvin McCuen.)

Mr. Melville: Yes, your Honor.

The Court: Very well.

By Mr. Melville:

Q. Mr. McCuen, have you had any experience in dealing in oil royalties?

A. No, I have not.

Q. Have you had any experience in dealing in stocks of oil royalty companies?

A. Well, I have bought or recommended people to buy producing oil corporations who had some royalty interests, yes. [401]

Q. But they were oil companies such as what?

A. The big oil companies here, Superior Oil and Union Oil.

Q. They produced and refined and marketed?

A. Yes.

Q. No companies that just sold——

A. The Superior Oil Company. I have also recommended this one up in Kern County, the Kern County Land Company. I have one account that has 500 shares of that and I keep an active interest in it.

Q. Would you say that that is more comparable to the Dominguez Estate Company than the other oil companies that you mentioned that are producing, refining and marketing?

A. Yes, in that it primarily owns royalty interests, and it has some producing land and some ranch lands.

Q. Do you know any other companies around

(Testimony of C. Melvin McCuen.)

Southern California that are similar to the Kern County in that regard?

A. Yes, here are some others. I think the Southland Royalty and the Louisiana Land and Exploration were very comparable.

Q. Do they have stock outstanding in the hands of the public? A. Yes.

Q. Sold on the local exchanges?

A. No, not on the—well, I think one of them is, and [402] they sold for about six to nine times earnings before depletion. The average of fourteen well-known producing oil companies, as I testified in my testimony here, sold for seven times their earnings in 1941 before depletion.

Q. But those oil companies that you had in mind were the oil companies that are like Standard Oil, aren't they?

A. No, those are Amerad, Barnesdale, Honolulu Oil, Midwest Oil, Mountain Producers and Superior Oil. They are producers only. They have no inventory, refineries, transportation or marketing facilities.

Q. Well, are they comparable?

A. They are more comparable insofar as the oil asset side of the Dominguez Estate is concerned.

Q. Why didn't you use them rather than to talk about banks and investment trusts?

A. I was getting at the asset value. I said that on June 5, 1941, as indicated by the Dow average, that stocks were selling down and assets sold at a discount, and I tried to indicate that if the assets

(Testimony of C. Melvin McCuen.)

of our outstanding leading banks and oil companies sold at about a 50 per cent discount, it was unreasonable to believe that a willing buyer would have paid on an asset basis only—of course, you should consider the earnings and the other factors here—would from an asset valuation only pay more for these assets than he would for those assets. At least, these assets which I have referred to support the values by earnings, whereas the Dominguez Estate Company cannot in my opinion support a \$760.00 valuation on earnings. \$47.00 will not at a fair ratio support such a value.

Q. Would you say from that that the asset value is too high?

A. I would say from that that the prospective buyer and willing seller——

Q. Answer the question. Was the asset value too high? A. It appeared too high.

Q. In other words, you have not approved of the stipulated figures as to the fair market value of those assets?

A. Well, as I understand it, those were the fair market valuations of those assets to the corporation. Now, the fair market valuation of an asset to a corporation is one thing, but when you convert it to stock value per share of common stock to a minority interest, that is an entirely different value from the other.

Q. What could the corporation have sold its stock—talking now about Dominguez Estate Company, Exhibit 1-A—— A. Yes.

(Testimony of C. Melvin McCuen.)

Q. What, in your opinion, could that corporation have converted its stocks and bonds and received cash for, in what amount?

A. Well, I would say approximately as per the stipulated [404] value of \$1,141,270.00. Of course, they hold some shares—they held rather sizeable blocks of stock which, if you had thrown them on the market that day, may have made a difference of a point or two or three points in value. I sold 500 shares of stock on the New York Stock Exchange last week and knocked the price down a point and a half on a very actively traded stock. Of course, from that you would have had a brokerage commission, so I would say on the whole that you would have got substantially in excess of \$1,100,000.00. Probably you would have got—they would have been probably \$40,000.00 off.

Q. All right, let us take the next figure, ranch real estate. How much could that have been converted into cash for, in your opinion?

A. I haven't the slightest idea. I do know at that time that ranch properties sold at a discount. I had the good fortune in 1941, in March of 1941, to purchase 40 acres which I bought for \$4,500.00.

Q. Do you have any views as to what the other real estate could have been converted into cash for?

A. No, I haven't. The sale of real estate properties in 1941—it was a very difficult thing to sell real estate in Los Angeles in 1941 at anything like its fair market value.

Q. You had those facts and situations in mind,

(Testimony of C. Melvin McCuen.)

did you, when you were making your analysis of this case?

A. They were a fractional part of all my knowledge [405] gathered together. That composed part of it, but I would say it was an infinitesimal factor.

Q. Would you distinguish between market price and fair market value?

A. Oh, well, of course, market price on the New York Stock Exchange is synonymous with fair market value in the estimation of many people, but in my definition of fair market value I am in total sympathy with the aims and objectives of the regulation of the Revenue Department. I think you ought to try to arrive at that price which a willing buyer under no compulsion to buy, and a willing seller under no compulsion to sell, each of them having all information of the relative factors involved, what they would have agreed upon. It is hypothetical but I think it is very interesting and perhaps the best way we have to solve these problems.

Q. That is something different, then, is it, from the market price? A. I think so.

Q. What is market price?

A. Market price is what a thing will fetch, whatever the market is, like today the market price of United States Steel is 78.

Q. That is the market price?

A. 78 per share.

Q. All right, what is the fair market price of United States Steel today? [406] A. 78.

(Testimony of C. Melvin McCuen.)

Q. The same? A. Yes.

Q. But you would define them differently?

A. Yes, I think so.

Q. Then define market price for us.

A. Well, in other words, as I say, market price is that price which a security will bring or fetch, it is an actual dealing, whereas fair market value involves considerations of investment values. It is consideration of both sides.

Q. Then, as I understand your testimony, market price is what a thing will bring?

A. Yes.

Q. Fair market price or value is what in your opinion it should bring or in somebody else's opinion it should bring?

A. What it should bring. In other words, it is more subjective and the other is more objective, but the two terms are sometimes used synonymously.

Q. But you do not use them synonymously?

A. Not necessarily. If they are in balance I will use them.

Q. And in this case——

A. What I have tried to do here is to arrive at the fair market value. I am taking into consideration the prevailing price of capital, the price of stocks and bonds all over [407] the country, and how I think those values—what effect it would have had on the value as of that date. The time is a very important element when you value a thing.

Q. In view of your testimony, would it surprise you to know that the parties agreed and stipulated

(Testimony of C. Melvin McCuen.)

that stocks and bonds could have been converted into cash, that that was the fair market value that would have been received for those stocks and bonds on May 31, 1941?

Mr. Mackay: Just a minute, if your Honor please. We stipulated the fair market value of those bonds at that date.

Mr. Melville: The testimony of this witness indicates that he did not understand the stipulation.

Mr. Mackay: I don't think he said that.

Mr. Melville: That is what I am trying to bring out if you will let me.

Mr. Mackay: I won't try to stop you, Mr. Melville.

The Court: You may proceed with your questions.

By Mr. Melville:

Q. Would it surprise you to know that the stipulation means that the ranch real estate could have been converted into cash for \$1,629,950.00 on May 31, 1941?

A. No, I would not be surprised because I think I am informed as to those stipulated values and what the purpose of it was. [408]

Q. Then why did you consider the real estate market and try to make a discount from that?

A. Well, I said, as of that date the real estate market in Los Angeles was depressed.

Q. What does that have to do with our case?

A. It has everything to do when you get down

(Testimony of C. Melvin McCuen.)

to the computation of a minority interest in a corporation which had no power to get those assets, assuming that those were the values to the corporation as of that date.

Q. But if the real estate market had not been depressed, is it not reasonable to assume that the fair market value of this real estate would have been higher?

A. It may have been higher or it may have been lower than that figure.

Q. There are stocks of oil royalty companies being bought and sold on the Los Angeles Stock Exchange, and over-the-counter, in Los Angeles, are there not?

A. I don't think there are any on the Los Angeles Stock Exchange. If there are, I am not familiar with them. The individuals generally get first choice at a good oil royalty. The corporations don't get those.

Q. There either is or there is not?

A. No, I don't think there is on the Los Angeles Stock Exchange, and I don't know of any over-the-counter. They are dealt in by specialists. [409]

Q. How about the San Francisco Stock Exchange, and over-the-counter at San Francisco?

A. I think you will find them over-the-counter.

Q. But you don't know?

A. Oh, yes, you definitely will, but you will probably find more here than you will in San Francisco.

(Testimony of C. Melvin McCuen.)

Q. You will find more over-the-counter sales here than in San Francisco? A. Yes.

Q. Then you will find over-the-counter sales both in San Francisco and in Los Angeles——

A. Yes.

Q. Of stocks of oil royalty companies?

A. Yes, sir.

Q. And they are also traded in on the New York Stock Exchange, aren't they? A. No, sir.

Q. How about the New York Curb?

A. If there are any on that I don't know of them, but I doubt if there are any on there.

Q. But here in California you had available to you at that time the fair market value, or the market price, as you call it, at which stocks of oil royalty companies were being sold?

A. No, I wouldn't say that, not the value, not the fair [410] market value at which they were sold. In other words, you would go up on the third floor and talk to a broker and ask him if he could get you a good royalty. Then after having got it, you would sit down and talk price, but there was no known, posted prices on them.

Q. You said that stocks of oil royalty companies were being traded in over-the-counter in Los Angeles and in San Francisco, didn't you?

A. I was confused. I was thinking—you are thinking of corporations?

Q. Stocks of oil royalty companies, sir.

A. I don't know of oil royalty companies that

(Testimony of C. Melvin McCuen.)

deal exclusively in oil royalties. I don't know of any such.

Q. Well, let us take Kern County.

A. I know, but we would not consider that an oil royalty company. I see what you mean now. That is a corporation and among the assets it has are oil royalties and cattle ranches.

Q. You have covered that.

Mr. Mackay: He has not said "cattle".

By Mr. Melville:

Q. But you have covered the fact that there are stocks, similar stocks to the Dominguez Estate Company, and you mentioned them.

A. That is the only one that is directly comparable. I would say the other three are not directly comparable. [411]

The Court: I would suggest that both the witness and counsel have a little bit of a habit of interrupting the other before the job in hand is completed. I don't say that to be critical.

Mr. Melville: I am sorry. I apologize to both of you.

The Court: You let counsel complete his question before you start to make your answer, and then if he will let you complete your answer before he starts the next question we will have a little better record.

By Mr. Melville:

Q. Then, as I understand it, in your opinion,

(Testimony of C. Melvin McCuen.)

Kern County is the only company that you know of that is really comparable to Dominguez Estate Company?

A. I would say it is the best of comparison that I can think of.

Q. Why didn't you use it in making your comparison?

A. I have it in the comparison here among the oil producing companies.

Q. You listed it right in or considered it right along with the companies——

A. The 14 other companies.

Q. Please don't interrupt me. You considered it right along with the other oil companies which are producing, refining and marketing, is that correct? [412]

A. No; producing companies only.

Q. Did you testify that the earnings of a corporation are one of the most important, if not the most important, factors to be considered in arriving at the fair market value of its stock?

A. Of a going concern, an operating company, that would be one of the most important factors. Of course, it is not altogether the most important factor. Some corporations do not have earnings but yet have assets of considerable value. In such cases you would minimize the earnings factor.

Q. If the Dominguez Estate Company had nothing except its real estate holdings in 1941, how would you have valued that on the earnings basis?

A. Well, I don't think I would have valued it

(Testimony of C. Melvin McCuen.)

on the earnings basis. I would have probably approached it as I did the Security Company. If you take out the oil royalties from the Dominguez Company, you would have a company very comparable to the Security Company, and I valued the Security Company there on the basis of its underlying assets.

Q. So, if you had valued the Dominguez Estate Company with no other assets except its real estate, you would have valued it on the basis of assets?

A. Well, on the estimated liquidating value of its assets if it had no earnings and if it had no working capital and had no stocks and bonds, but just real estate. Of course, I would [413] want enough cash and working capital to see the corporation through, but I would then have estimated the value of the real estate on the present worth basis.

Q. Mr. McCuen, if you knew that Dominguez Estate Company was actually bought and sold around about 1941 for \$1,000.00 a share, would that change your opinion as to the value of that stock?

A. I will answer it this way, that I have approached this——

Q. Just a minute. I believe you can answer that question yes or no, and I wish you would do so, following it with your explanation.

A. No, it would not have made any difference in my valuation here.

Q. You would not change your opinion if you knew there was an actual sale of that stock at \$1,000.00 a share?

A. No, sir, because I brought forth the best of

(Testimony of C. Melvin McCuen.)

my integrity and ability to compute this value, and while I may have been disappointed to find that I was that far off, as I sometimes am disappointed in my calculations of values and how they work out in the future, it would not have changed my opinion one bit.

Q. So that all that this sale or sales at \$1,000.00 a share would do, as far as you are concerned, is to establish that that was the market price? [414]

A. The market price and not the fair market value.

Mr. Melville: No more questions.

Mr. Mackay: That is all.

(Witness excused.)

Mr. Mackay: Call Mr. Eitner.

ADOLPH K. EITNER,

called as a witness for and on behalf of the Petitioner, having been first duly sworn, was examined and testified as follows:

Direct Examination

The Clerk: Your name, please?

The Witness: Adolph K. Eitner.

By Mr. Mackay:

Q. Mr. Eitner, you live in Los Angeles?

A. Yes, sir, I do.

Q. What is your occupation?

A. I am an investment banker.

(Testimony of Adolph K. Eitner.)

Q. With whom?

A. Blythe & Company.

Q. Is that the Blythe & Company that is known nationally and internationally?

A. Yes, sir.

Q. How long have you been connected with that company?

A. For twelve and one-half years. [415]

Q. In what capacity?

A. Well, in the past three and one-half years as sales manager in Los Angeles; before that time as statistician, analyst and buyer, working in the buying department.

Q. Prior to that time what was your occupation?

A. It was the same.

Q. For how long prior to that time?

A. From July of 1926.

Q. What has been the nature of your duties since that time, and particularly during the last five or six years?

A. It has been constantly working with securities, appraising security values, both on securities which have established markets and in other instances securities which do not have established markets which we are checking for the purpose of either public or private placement.

Q. You say you are at the present time sales manager for Blythe & Company?

A. In Los Angeles, yes.

Q. And you buy and sell—you have bought and sold a lot of stocks?

(Testimony of Adolph K. Eitner.)

A. Yes, we buy stocks here for the account of the firm, buy them and sell them. I handle a good bit of that.

Q. Now, have you formed an opinion as to the fair market value of this stock of the Dominguez Estate Company as of June 5, 1941? [416]

A. Yes, sir, I have.

Q. Were you supplied with a copy of the stipulation that has been submitted here, together with the exhibits?

A. Yes, sir, I have had those and examined all of them carefully.

Q. And you have made an analysis of those exhibits? A. Yes.

Q. Those exhibits, or some of them, show that all the assets of the Dominguez Estate Company, or each of the assets of the Dominguez Estate Company—withdraw that.

You are familiar with the fact that one of the exhibits shows that the parties have stipulated the fair market value of certain assets of Dominguez Estate Company? A. Yes, sir.

Q. As of that particular date?

A. Yes, sir.

Q. And the only asset not stipulated and which is at issue is the oil royalties of the Dominguez Estate Company? A. Yes, sir.

Q. You are familiar with that?

A. Yes, sir.

Q. In arriving at your value or market value of the stock of the Dominguez Estate Company as

(Testimony of Adolph K. Eitner.)

of that date, what value did you assume or take on the oil royalties?

A. There was another exhibit in connection with the [417] exhibits, and that is the exhibit of expected future royalty income. I don't have it here but I think this is correct from the standpoint of round figures, that the gross projected royalty income to the Dominguez Estate Company was roughly \$9,000,000.00. I discounted that to a present value, using a 6 per cent factor which breaks—

Mr. Melville: Just excuse me one moment, please. Has this witness been qualified to appraise oil royalties?

Mr. Mackay: He is just explaining how he arrived at that. I asked him what value he assumed.

Mr. Melville: He is undertaking to value for the record, as I understand it, oil royalties by starting with the \$9,000,000.00 odd figure and I don't believe the witness has been qualified as an expert to value oil royalties. That is one of the issues in the case.

By Mr. Mackay:

Q. What has been your experience along that line, Mr. Eitner?

A. In connection with oil royalties I have had no experience. We have handled the securities of companies that are mainly producing oil companies, and in one instance an oil royalty company. In another instance we have—in several instances I can recall going into producing companies, and in

(Testimony of Adolph K. Eitner.)

one case a royalty company, in some detail, but no transaction resulted, we could not arrive at a valuation in our own minds [418] which was satisfactory to the prospective seller at the time. So, in proceeding to answer your question, I was not attempting to establish a value of the royalty. I was attempting to establish the value which the royalty represented in the stock, if that is satisfactory.

Q. Yes.

Mr. Melville: Go ahead.

The Witness: I took a 6 per cent factor and brought that down to the present worth, which is roughly \$5,868,000.00. The Dominguez Estate Company paid taxes at a rate of about 15 per cent of their taxable income, which, from a practical standpoint, represented entirely the royalty income. So, deducting taxes from that at the rate of 15 per cent, we get a present worth factor there from the gross figure of \$9,000,000, whatever it was, of \$4,988,600.00, which is the equivalent of \$475.00 a share on the Dominguez Estate stock. That is my valuation on the stock and that is the value which I considered in the royalty. Does that answer you on that point?

By Mr. Mackay:

Q. Yes. Assuming that the fair market value of the oil royalty of the Dominguez Company on the basic date was \$3,000,000.00, as testified to by Paul Paine yesterday, and in the light of this stipu-

(Testimony of Adolph K. Eitner.)

lation and the exhibits, what would be the fair market value?

A. Well, sir, I did not consider the market value of the [419] royalty in the strict sense of that term. The figure that I arrived at—are you asking the figure that I arrived at overall on the Dominguez Estate stock?

Q. Yes, I wish you would give it, please.

A. It is \$407.00 per share.

Q. All right, proceed.

A. In considering this, in approaching this, I, of course, studied and analyzed the earnings statement, the dividend record, the financial statement, and the stipulation of values. The assets broke down into several distinct types. You have, of course, your current assets which are a necessity in any going concern. That is one group. You have your securities, another group. You have your ranch real estate, which had been unprofitable according to the record, in another group. You have another real estate group which had been earning at the rate of about roughly \$50,000.00 a year in the years immediately preceding this valuation date. Then you have those oil royalties which produced the bulk of the income.

I reduced those to a per share basis. The net current assets were \$55.00 per share, and I carried this over to a resultant value of \$55.00. The stocks and bonds on a per share basis are equal to \$109.00 per share. I applied a 30 per cent discount factor to that in arriving at a fair market value, and the re-

(Testimony of Adolph K. Eitner.)

sultant figure is \$76.00 a share. I [420] don't know whether I should go into the discount factors.

Q. I wish you would.

A. Well, I used the general \$30.00 asset values of Lehman Corporation and National Bond and Share, which are both listed investment trusts on the New York Stock Exchange. Lehman Corporation was \$20.75, and the asset value was roughly \$28.75, so there was a 20 per cent discount. National Bond and Share, which is listed on the New York Stock Exchange and has no senior security issue, it has only one class of stock, was around \$15.00 and the asset value was \$21.25. The discount was 29 per cent. On the Security Company the discount was about 38 per cent. Those are the only ones that I have made notes of here before me, but in singling those out, I considered a number of others. I considered those to be about as representative and conservative as you could find in the field, and concluded that applying a 30 per cent discount to the stocks and bonds of Dominguez Estate Company, which did not have the standing or would not have the standing of Lehman Corporation or National Bond and Share, was reasonable.

On the ranch real estate the per share value was \$155.00. I applied a discount factor of 75 per cent to that.

Now, these discount factors I might clarify myself on here to save confusion. They are not a factor that I am applying or questioning on the stipulated value. They are the factor that I am

(Testimony of Adolph K. Eitner.)

applying to the value which I see represented [421] by those assets in the stock itself. I am talking now about the values as they are reflected in the stock itself.

Q. Yes.

A. In arriving at the 75 per cent discount which might appear at first blush to be extreme, we have had—there are comparatively few securities of ranch real estate or general real estate companies that are dealt in freely in the market that are any sort of index. There are a couple out here in California. There is the Marblehead Land Company locally which is not ranch real estate. They have this real estate out in Santa Monica. They had and still have some bonds outstanding and at that time they were selling at around 20 cents on the dollar. I took those because we have had a number of transactions with the company and know the management and had a good idea at that time as to how they considered the future would work out so far as those bonds were concerned. The Sutter Basin Company, I think the work-out has been better than they anticipated. The Sutter Basin Company owned some farm lands up here in Northern California and they had some bonds outstanding which traded with the stock, and they were trading at around 35 cents on the dollar. Now, both the Sutter Basin Company and the Marblehead Land Company were definitely liquidating propositions, liquidating real estate propositions. They were actively selling the real estate, and with the proceeds from

(Testimony of Adolph K. Eitner.)

the sale of the real estate they would [422] go into the market and buy their own securities, and they had already bought very substantial amounts of their own securities, and to that extent the market value for their securities would be influenced to be high rather than to be low.

There is a company locally that might be thrown in as a comparison, and that is this Los Angeles Investment Company. They had some stock out at the time, and still do, in fact. That was selling at around $77\frac{7}{8}$. The liquidating value of the Los Angeles Investment at that time in the opinion of the management was around 18 to 19 a share, so, that figured a value of 43 cents on that day. However, in the sales of the other two there was a distinct liquidating program which sets a favorable and high market for the stock. Without that buying interest in the market there is every reason to assume that all three of those securiteis would have been selling much lower. Well, that covers the 75 per cent discount. You have your per share of \$155.00 as reduced to \$39.00 as represented in the stock.

Other real estate of \$1,631,000.00 is roughly \$156.00 a share. I applied a 50 per cent discount factor to that and arrived at a fair market value in the stock as represented by the stock of \$78.00 a share.

Now, in appraising that, I took into consideration that that represented building properties which were producing [423] some earnings, roughly

(Testimony of Adolph K. Eitner.)

\$50,000.00 a year. That \$50,000.00 a year reduced to a figure on my valuation is about 6.4 per cent return on the investment which would indicate a comparatively high value in comparison with other prices that were in the market at that time. [424]

You had the Taft Building 6 per cent bonds outstanding which were around 66 to 69, so that at the 6 per cent rate the return there would be around $8\frac{1}{2}$ or better per cent.

Russ Building 6's, 1951, would be selling around 90. That is in San Francisco and it is a first-class office building with a good record, and the returns there would be roughly 7 or $6\frac{1}{2}$ per cent, figuring the yield to maturity.

Subway Terminal Building bonds, in Los Angeles, paying 4 per cent interest and just earning it, were selling around 30.

Central Hollywood, or Equitable Building, bonds, which were paying interest at about 5 per cent and showing earnings about double that amount, were selling at about 75 to 80, with the stock.

So, that covers the 50 per cent discount there.

Now, on your oil properties, from the figure of \$475.00 a share I took a discount factor of 45 per cent, which produces a figure of \$261.00. Now, the reason I took the discount factor of 45 per cent is mainly in comparison with the common stock of the Dominguez Oil Field Company. The major assets of the Dominguez Oil Field Company were certain leases which were covered by some of the

(Testimony of Adolph K. Eitner.)

royalties. We were members of an underwriting group which, I think in November of 1938, had acquired and offered publicly a [425] substantial block of Dominguez Oil Field Company stock in the market. We paid 32½ a share for it and offered it for 36. The price on June 5, 1941, was \$30 a share. The stock had paid \$3 in dividends. In fact, in 1939 I think it paid a little extra, and in 1938 there was, I believe, a fairly substantial extra dividend paid.

At the time we bought the stock we proceeded on the basis that we would have to get a report from a responsible geologist and oil engineer and we asked Mr. Payne if he would make an examination of the properties and project figures as to what one could expect in the way of earnings. He did that and came up with a tabulation which is rather similar to the exhibit. Then he eliminated from that the projected expenses and projected taxes, discounted it at a 6 per cent present worth factor, and came up with assets there of \$65.00 a share. We paid \$32.50 for the stock, or 50 per cent for it. In 1941, with the stock at 30, after it had been out for two years, it was selling at a figure which was less than 50 per cent, and that is how I accomplished this 45 per cent discount factor.

The Court: We will suspend for a brief recess.

(Short recess.)

A. (Continued) I think we had—can I just pick it up?

(Testimony of Adolph K. Eitner.)

By Mr. Mackay:

Q. Yes, please.

A. I think we had come down to the 45 per cent discount factor on the oil properties, arriving at a resultant value of \$261.00 a share. Adding all these figures together you get a figure of \$509.00. Now, that, I believe, would have been the value of the stock had it been a stock which had a ready and active market in the common sense of the term, and general information on it would have been generally available, and all that sort of thing. Without that, in other words, because of the absence of the market, because of the fact that it is a personal holding company, because of the fact that we are talking about a minority interest, and that sort of thing, I am applying a 20 per cent discount to the total here, which amounts to \$102.00, bringing the figure out at \$407.00 a share. This price of \$407.00 is a capitalization of the 1940 earnings at 11.6 per cent. It is a capitalization of the 1939 earnings at 13.9 per cent. It is a capitalization of the \$72.00 dividend, which was earned to the extent of \$24.70, at 17.7 per cent.

That, I think, covers it as far as the Dominguez Estate is concerned.

Q. So, then, your opinion of the fair market value of the Dominguez Estate Company stock on that date was what? A. \$407.00.

Q. Did you determine an opinion of the fair

(Testimony of Adolph K. Eitner.)

market [427] value of the Francis Land Company stock on that date?

A. Yes, sir, I have.

Q. Will you please tell how you arrived at that?

A. From a practical standpoint the only asset of Francis Land is the 5,499 shares of Dominguez Estate. That is 1.0908 shares of Dominguez Land for each share of Francis Land, or 1.1 for practical purposes. This produces \$447.70 a share on Francis Land. The true assets in this company are in Dominguez, not in Francis, and the Francis Land stock is one step removed through its ownership of Dominguez stock. Therefore, I do not believe you can take the full figure of \$447.70 per share of Francis Land, but that you must discount it, and I am discounting it by 5 per cent, which is possibly too low a discount, and that produces a figure of \$425.50, which in my opinion is the fair market value on that date.

Mr. Melville: What was that again?

The Witness: \$425.50.

By Mr. Mackay:

Q. And did you also arrive at the fair market value of the Carson Estate Company stock?

A. Yes, sir. I have arrived at a value of \$230.00 a share on Carson Estate Company stock.

Q. Will you please tell the court how you arrived at that? [428]

A. The Carson Estate Company is a sort of small Dominguez Estate, in a way. You have the

(Testimony of Adolph K. Eitner.)

current assets, you have the ranch real estate, and you have the other real estate, which in the case of Carson is non-productive. You have a very small royalty interest, and then you have the Dominguez stock and Francis Land Company stock which is owned by Carson. Now, in order to simplify the procedure, I have reduced that straight back to Dominguez, and in this case that establishes that there are .4475 shares of Dominguez in each share of Carson. Now, following through the same line of reasoning that we have on the Dominguez Estate, taking your next parent assets, which amount to \$22.00 a share, at \$22.00; taking your ranch real estate, which is at \$60.00, at a 75 per cent discount, which results in a figure of \$15.00 a share; your other real estate, which amounts to \$20.00 a share, and applying a 75 per cent discount—it is non-productive entirely—brings you to a figure of \$5.00 a share. The oil properties on the same present value basis as we applied in Dominguez but without any tax deduction—and the reason that I did not take any tax deduction was that Carson was apparently in a position to minimize his tax expense—we bring a gross figure of \$356,500.00, which is \$48.00 per share. Discounting that by 45 per cent, we get a figure of \$27.00 a share. Then we have the Dominguez stock, .4475 shares at the undiscounted figure of \$509.00 a share— [429] we don't want to pyramid discounts—we have a personal holding company and a no-market situation here and all that, less the 5 per cent because of the

(Testimony of Adolph K. Flitner.)

removal from the original source, amounts to a figure of \$217.00. Totalling that at \$286.00 and applying a 20 per cent discount accomplishes a figure of \$230.00 per share. The 20 per cent discount is for the personal holding and the absence of a market, the small minority position, and factors of that sort.

Mr. Mackay: You may take the witness.

Mr. Melville: May I suggest, your Honor, that it is a quarter of 5:00?

The Court: I think we will proceed.

Cross Examination

By Mr. Melville:

Q. How much of a discount factor—going back now to Dominguez—how much of a discount factor did you apply to current assets? A. None.

Q. Your discount factor with respect to stocks and bonds was 30 per cent, I believe?

A. Correct.

Q. I don't understand fully just why you used 30 per cent. You are in the brokerage business?

A. No, I am in the investment business. We buy and [430] sell for our own account; we underwrite rather than act as brokers.

Q. Of all of the assets that are included within the frame work of Dominguez Estate Company, your business is most familiar with the stocks and bonds, more so than with real estate or——

A. That is correct.

(Testimony of Adolph K. Eitner.)

Q. ———or oil royalties?

A. That is correct.

Q. So, tell us, if you will, just why you arrived at 30 per cent.

A. Investment trusts which do not have a so-called syndicate market, which is an entirely supported market, consistently have sold at discounts for the past 15 years from the asset value of the securities themselves. By "asset value" I mean the aggregate market value divided by the number of shares.

In the case of the two most representative, which are listed and traded on the New York stock exchange and can be assumed to have probably the broadest market, and which do not have a leverage factor in that they do not have senior securities out, in other words, they are comparable to Dominguez which does not have senior securities out—the one that was available on June 5th at a price equal to a discount of 27 per cent from the asset value, the National [431] Bond & Share, was at a discount of 29 per cent.

Now, I cannot visualize a willing buyer that is informed of all the facts who will pay a price for what is represented by the investment account of the Dominguez Estate Company that is more than he would pay for the equivalent in Lehman Corporation or National Bond & Share, and for that reason I have applied the 30 per cent discount to it.

Q. That is Lehman Brothers?

(Testimony of Adolph K. Fitner.)

A. And National Bond & Share. National Bond & Share is a trust that has been more or less sponsored by Domenick & Domenick.

Q. And both these securities outstanding, I mean, stocks of their companies are publicly owned?

A. Yes, and traded on the New York Stock Exchange.

Q. Now, supposing that the stocks and bonds in the Dominguez Estate Company consisted entirely of stocks of Lehman Brothers and National Bond & Share, would you still discount them 30 per cent?

A. Yes, sir, I would.

Q. Why? You have already taken a 27 and a 29 per cent discount from the——

A. You have no assurance that they are going to be retained in Lehman Brothers or National Bond & Share. The management might see fit to sell, and that is all you can realize for them and that is the figure that you take into account in the asset value of an investment trust. [432]

Q. You say the figure you can realize?

A. The asset value, the figure that we are talking about, is the aggregate market value represented by the investment of these trusts divided by the number of shares. Now, whether that be government bonds, whether that be other investment trusts, whatever that be, there is no assurance that it is going to continue in that position. This is all hypothetical, anyhow, that is, your question is. I believe that the same factors should be applied under the circumstances.

(Testimony of Adolph K. Eitner.)

Q. All right. Then the stock of Dominguez is owned by Francis, and why would not another 30 per cent apply?

A. Francis, apparently—I don't know, frankly, the reason that Francis Land Company—I believe that I have been very liberal in applying a 5 per cent discount factor.

Q. But that does not answer the question. Going back now, if Dominguez Estate Company owned—going all the way back, Lehman Brothers owned certain securities? A. Yes.

Q. The sales price or fair market price of Lehman Brothers stock about our basic date reflected a discount of 27 per cent over the fair market value of the stocks which it held, is that correct? A. That is correct.

Q. And the same thing is true now with National Bond & Share except the discount was 29 per cent?

A. That is correct.

Q. Now, you say that if the Dominguez Estate Company had \$1,141,269.74 invested in the stocks, exclusively the stocks of Lehman Brothers and National Bond & Share, you would still take a further discount factor of 30 per cent?

A. That is correct.

Q. Now, one step further.

Francis Land has all of its money, that is, its stocks and bonds, in the stock of Dominguez Estate Company? A. That is correct.

Q. Just why wouldn't you take another 30 per cent?

(Testimony of Adolph K. Eitner.)

A. Dominguez Estate Company does not have a ready and active market. You cannot establish the asset value in the sense of the term that we are applying it in this case. I am going back to the original asset in this case. Now, you have one example that is somewhat comparable, and that is where you have a holding company or an investment trust, or call it what you will, which holds, from a practical standpoint, only one stock or security, and that is this Christiana Corporation, which owns a substantial amount of DuPont, and a nominal amount of General Motors. That stock on June 5th had an asset value of about \$2,500.00 a share—excuse me—\$2,900.00 a share. The market value on it at that date was around \$2,400.00. So, you have a discount there and you have the similarity of the one asset. [434]

Q. Did you consider that at that time with respect to Christiana when you——

A. Yes.

Q. Did you study Christiana Securities carefully? A. Yes.

Q. Do you know when those securities were purchased by Christiana?

A. Many, many years ago, I think.

Q. If Christiana sold its assets and liquidated as of June 5, 1941, it would have had tremendous capital gain taxes to pay, wouldn't it?

A. I frankly don't know. It is an assumption that they will not liquidate and sell and that you are going to have a continuing interest in the

(Testimony of Adolph K. Eitner.)

General Motors and in DuPont which prompts the buyer to purchase the stock.

Q. Do you know the cost of a share of Christiana when it was originally issued?

A. No, I don't.

Q. You did not go back of the 1940 or 1941 period?

A. No. On Christiana? No, I have not.

Q. You did not make a very careful study of it, then, did you?

A. Well, I made a study to this extent, that we know the make-up, I mean, we know the make-up of the assets of Christiana, the fact that they serve as a market for DuPont, and the preferred stock that is outstanding, and we arrive at this calculation. Now, there is no proper reason to assume that liquidation and the assumption of tax liabilities are in prospect. It is simply a medium for buying DuPont a little bit cheaper to the investor, and the only reason he would buy it is because he can buy his DuPont a little cheaper that way.

Q. Is it not a fact that Christiana Securities were selling in 1941 at our basic date at more than the liquidated asset value, the fair market value of the assets less taxes?

A. Now you are not talking about the aggregate sale price. You are talking about the deduction of taxes, and so forth.

Q. Let us assume the Christiana Securities liquidated in 1941.

(Testimony of Adolph K. Eitner.)

A. I don't know what the tax liability would have been.

Q. You cannot answer the question, then?

A. Correct.

Q. You spoke in direct examination about the absence of a market for Dominguez Estate Company stock? A. Correct.

Q. And you took a discount factor for that, I believe? A. Correct.

Q. Would it surprise you to know that there was a ready market for Dominguez Estate Company stock? [436]

A. It would surprise me, yes.

Q. And would you change your testimony if that is established as a fact in this case?

A. In other words—may I rephrase your question to see if I understand it clearly?

Q. Yes.

A. In other words, let me assume that if I have some Dominguez Estate Company stock I can be assured of selling it at a certain figure, or I can just be assured of selling it?

Q. Selling it at a fair figure.

A. Under duress?

Q. No.

A. Or pressure? No, because I believe the figure would be approximately the figure that is arrived at here, within reach of that.

Q. Do you know of any sales of the stock of the Dominguez Estate Company at any time?

A. No, sir, I do not.

(Testimony of Adolph K. Eitner.)

Q. If there was a sale of the stock of the Dominguez Estate Company in—well, let us say, June, 1941——

A. June 5th.

Q. —June 5th, 1941, at \$1,000.00 a share between a willing buyer and a willing seller, would that be in your opinion the fair market value of that stock? [437]

A. I would want to be familiar with the circumstances of sale. I would like to know who the buyer was and who the seller was.

Q. The buyers is a willing buyer, well informed, and the seller is a willing seller, well informed, neither being under any compulsion or duress to buy or sell; would that in your opinion establish——

A. How many shares?

Q. Let us say 100 shares. Let me ask you this, isn't 100 shares the usual unit in buying and selling stocks and bonds?

A. No, not necessarily.

Q. Well, if you buy less than 100 shares you pay a premium, don't you?

A. Not necessarily. There are lots of 10-share markets and 5-share markets.

Q. All right, we will talk about 100 or 200 shares.

A. I don't believe that a single transaction—I think it would influence my ideas some, but I do not believe, however, that a single transaction on a single date between a willing buyer and a willing seller establishes a fair market price. If there were a series of transactions, then you are talking about something.